Fostering Economic Growth:
The Role of Financial Companies

United States Senate

Committee on Banking, Housing, and Urban Affairs

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Chairman – National Association of Corporate Treasurers

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Chairman Crapo, Ranking Member Brown, and the other members of this Committee:

Thank you for the opportunity to testify at this important hearing focusing on our country's future economic growth. I am Thomas C. Deas, Jr., recently retired vice president and treasurer of FMC Corporation and current chairman of the National Association of Corporate Treasurers ("NACT"), an organization of treasury professionals from several hundred of the largest public and private companies in the country. I also represent the NACT on the Steering Committee of the Coalition for Derivatives End-Users (the "Coalition"), comprised of several hundred companies that employ derivatives to manage risks in their day-to-day business activities, principally through the dedicated efforts of their corporate treasurers.

At the outset, I would like to thank you, Chairman Crapo, for your efforts to make sure that end-users are able to engage in prudent risk-management activities without facing costs that could make such activities prohibitively expensive. We appreciate your efforts to move a bill, enacted in the last Congress, to exempt end-users from unnecessary margin requirements.

Background on End-Users' Interactions with the Financial System

I am thankful you have asked me to assist your efforts to foster future economic growth by ensuring that American Main Street companies can interact in ways that make sense economically with the financial system you help to oversee. The financial system is critical to the day-to-day business activities of end-user companies, including through activities such as:

- Collecting payments from customers
- Concentrating cash collections in secure depository institutions
- Sending cash safely from where it was collected and concentrated to wherever it is needed to meet the company's day-to-day business obligations to suppliers, employees, government entities, investors, and others due payments
- Borrowing or investing to meet temporary or longer term cash shortfalls or surpluses

- Managing the company's capital structure with adequate committed credit and appropriate amounts of debt and equity capital with repayment obligations to investors structured to limit risks, especially anticipating future periods when liquidity may be constrained
- Identifying and hedging the company's financial risks from exposures to such factors as:
    - Interest rates
    - Foreign exchange rates
    - Commodity prices

End-users are fundamentally different from financial companies in that they use the financial system to facilitate their business operations and they do not engage in speculative, inherently risky position-taking as do some financial firms. For example, end-users employ derivatives to reduce risks arising from operating their businesses and do not engage the kind of transactions that roiled the markets during the financial crisis. End-users comprise less than 10 percent of the notional amount of the over-the-counter ("OTC") derivatives market and do not meaningfully contribute to systemic risk. However, in markets as complex and interrelated as we have now in the global financial system, there is a clear need for a regulatory framework that recognizes these complex interactions. We have been gratified at the bipartisan consensus that has developed since the financial crisis that:

- end-users employ the financial markets to reduce risk and, therefore their activities should not be unduly burdened, and
- recognizing that the financial markets in today's world are truly global, American companies and their workers should have a consistent, predictable, and level regulatory playing field in which they do not suffer any relative disadvantages compared to their foreign competition.

We believe a clear understanding of end-users' interactions with the financial system is critical to maintaining a regulatory framework that does not burden the end-user producers and job creators with the costs of well-intentioned measures more appropriately applied to financial firms. With these complexities in our increasingly interrelated markets, it can easily be the result that a regulatory change at one end produces an unintended consequence and higher costs on end-users several steps down the chain. Further, foreign regulators have in certain cases granted exemptions to end-users that are not available under U.S. law, placing American end-users at a competitive disadvantage compared to their foreign competitors.

Since its start in the early 1980s, the OTC derivatives market has grown to be the largest financial market in the world with outstanding transactions totaling nearly $700 trillion in notional amounts.[1] Transactions between swap dealers and other financial intermediaries represent most of the trades, with non-financial end-users comprising less than 10 percent of derivatives activity, as mentioned above. However, much of the trading by financial intermediaries can be assumed to be transactions to balance risk positions that originated with end-user trades. The exponential growth in the derivatives market came in significant part from end-users in the real economy needing to hedge their exposures to changes in interest rates, commodity prices, and foreign exchange rates, along with credit exposures to customers or suppliers, exposures to equity prices, and other commercial risks they face in their day-to-

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[1] Bank for International Settlements OTC derivatives statistics at http://www.bis.org/statistics/derstarts.htm.

day business operations. OTC derivatives can be matched exactly as to timing, currency, rates or amounts of the underlying exposures in ways that the futures markets, with round lots and fixed settlement dates could not. The customization available in the OTC derivatives market has been essential in allowing end-users to match exactly derivatives with underlying business exposures so that they move in equal, but opposite ways. Additionally, OTC derivatives together with relevant regulatory exemptions allow end-users to negotiate credit support measures individually with their derivatives counterparties.

Today I propose to focus on a few areas in which certain regulatory changes could benefit Main Street companies so that we can grow our businesses and increase employment opportunities for our American workers.

Day-to-Day Business Examples of End-Users' Interaction with the Financial System

End-user corporate treasuries today routinely use the financial system to facilitate their day-to-day business tasks. However, they are matching exactly in amount, currency, and duration the financial transactions with the business flows they are managing. Instead of speculating, for example in foreign currencies, through a foreign exchange transaction unmatched to a committed business transaction, an end-user is offsetting a known transaction to lock in the price and manage the risk of future movements in the currency markets.

Corporations engaged in manufacturing activities with their costs in one currency and selling into foreign markets in another currency have access to derivatives transactions that will allow them to hedge this cross-currency risk. Depending on the predictability of future sales, they can enter into forward sales of the selling currency while taking back payments in the currency in which they are incurring their manufacturing costs. Since the future sale is not yet recorded on the corporation's financial statements, it is important to achieve the objective of reduced earnings volatility, that changes in the derivative's valuation be deferred from being recognized in income until the anticipated sale is actually made and recorded on the end-users' financial statements, creating an offset. Accounting rules in the U.S. and Europe generally permit this treatment.

Multinational manufacturing groups have often sought to locate production facilities where they can match the currency exposures of their production costs with anticipated revenues in the same currency. This is referred to as creating a "natural hedge" of like-currency offsets and reduces the need to hedge in the OTC derivatives market. Multinationals are monitoring the increasing costs and operational complexities of cross-border derivatives regulatory compliance. By keeping end-users' regulatory burdens appropriate to the actual financial risks their transactions represent, we sustain U.S. manufacturers' ability to produce at home, export abroad, and manage the cross-border currency risks with derivatives whose costs are not too expensive.

Commodity derivatives are used by end-users' corporate treasuries to manage movements in prices of raw materials used in their production or goods they sell. Consider a manufacturer using natural gas in its production. It can fix the price of this important cost component by entering into a fixed-price contract with one of several deregulated natural gas suppliers. This effectively embeds a derivative in its

supply agreement. Alternatively, it can enter into a floating-price purchase contract and have its corporate treasury arrange a matching commodity derivative in which it pays a fixed price and receives the floating price it passes on to its supplier. With either arrangement, there is a risk to the corporation that its price-locked structure fails when the mark-to-market is in the money to the corporation. It is generally far easier to monitor the creditworthiness of a swap counterparty, often a regulated financial or trading institution, than to try to monitor an energy supplier. This in part is why end-user businesses are increasingly relying on the derivatives market to hedge commodity price risks.

Another important use of commodity derivatives is to allow structuring cross-border bartering transactions. Consider a multinational agricultural chemicals manufacturer selling into Brazil. Like its fellow BRIC countries, Brazil has plentiful land and labor as classic economic inputs to production, but less access to capital and associated financial markets. The multinational chemicals company can, however, access the global derivatives markets. Its customer in Brazil needs crop-protection chemicals at planting time, but can only pay six months in the future, at harvest time. During this period, the Brazilian farmer has commodity price risk and currency risk. The multinational manufacturer arranges a barter trade where the Brazilian farmer agrees to pay in soybeans at harvest time six months forward for the chemicals it needs to apply at planting time. The farmer has transferred the commodity price risk to the chemicals manufacturer, which can enter into a customized OTC commodity derivatives locking in the U.S. dollar price six months in the future, thereby hedging its risk in the derivatives market.

In some cases, large sales requiring several years to fulfill may motivate a supplier to enter into a credit default derivative to hedge the risk that its customer goes bankrupt before it is paid. A credit default derivative can be structured for a notional principal amount sufficient to mitigate the payment risk. As discussed below, the amount of capital regulated swap counterparties have to hold against this type of trade as an aftermath of the financial crisis make it a costly hedge for most corporate treasuries to enter into.

By reducing the overall volatility of its business results, the end-user corporate treasurer contributes to the stability and predictability of his or her business. If done consistently and communicated properly to stakeholders, the result is a lower overall riskiness for the end-user business, justifying a lower risk-adjusted discount rate for its estimated future cash flows and hence a higher valuation.

Capital Requirements

A bipartisan effort in the last Congress, supported by the leadership of Chairman Crapo, resulted in the enactment of a clear end-user exemption from having to post cash margin for end-users' derivatives positions.[2] However, we are increasingly concerned that the uncleared OTC derivatives we seek to continue using to reduce our business risks will become too costly because of much higher regulatory

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[2] *See* 7 U.S.C. § 2(h)(7); 7 U.S.C. § 6s(e)(4).

capital requirements imposed on the financial companies that we rely on as our derivatives counterparties.

The Prudential Banking Regulators have now finalized rules implementing Basel III capital requirements which increase the capital bank counterparties are required to hold against derivatives. Additionally, other bank capital measures, including the net stable funding ratio ("NSFR") and the supplemental leverage ratio ("SLR"), risk further increasing derivatives transaction pricing and loans for end-users.

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.

The lack of a CVA exemption for U.S. end-users that are hedging their commercial risks would deny or significantly reduce the end-user community the benefits of the statutory exemptions from clearing and margin requirements as end-users that engage with banking organizations that are the subject of the CVA charge imposed by the U.S. Prudential Banking Regulators see those charges passed through in the form of higher pricing. Such a result thwarts the will of Congress to provide clear exemptions for American end-user companies.

Further, the CVA charge may force end-users to post collateral to offset banks' CVA capital requirements. If banks require collateral, end-users may be put in the position of borrowing from financial institutions to obtain the cash required to support those transactions, resulting merely in a shift of risk between financial institutions. The result of requiring the posting of collateral contradicts the objective of facilitating end-users' 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.

Net Stable Funding Ratio

We believe the Prudential Regulators' June 2016 proposal on the NSFR could lead to billions in additional funding requirements for end-users' derivatives and borrowing activities. 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 are concerned that long-term funding costs required under the NSFR might 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. Additionally, 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 end-users' long-term business 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.

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 mitigate risk efficiently.

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 the collateral posted by end-users 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. 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 of end-user notes, 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 in the market. The NSFR rules require the bank to hold 85% of that overnight funding as long-term funding—at a cost multiple 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 SLR is another capital requirement imposed on financial institutions that flows through to end-users through the lack of an end-user exemption. The 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 customers, including end-users, even though the initial margin is expressly for the purpose of limiting the clearing member's exposure to the derivative it is clearing. 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. On the whole, 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.

In summary, although a bipartisan consensus in the last Congress confirmed the original legislative intent of the Dodd-Frank Act to exempt end-users from having to use their own capital for mandatory margining of derivatives transactions, capital requirements imposed on banks would seem to 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 and ultimately consumers.

Cross-Border Harmonization of Regulations in the Global Financial System

NACT and the Coalition appreciate the important efforts being undertaken by U.S. and foreign regulators to resolve differences in how their regulations apply to cross-border transactions. Applying derivatives reform rules in a global marketplace is an inherently complex undertaking. Unlike most stock market transactions, a derivative creates an ongoing relationship between parties that continues from its initial inception until its final termination in the future. Thus, many transactions exist between parties in different jurisdictions for many years. While the United States has completed many of its derivatives rules, other regulators around the world are just now finalizing and implementing many of their rules. Consequently, derivatives end-users now find themselves simultaneously subject to multiple regulatory regimes. Understanding and implementing compliance structures for derivatives rules across multiple jurisdictions is a significant and costly undertaking. Accordingly, American end-users are subject to incentives to avoid complication by limiting their transactions to counterparties located in their same jurisdiction. The lack of regulatory harmonization can cause fragmented and less efficient markets for end-users, and can raise the cost of delivering stable prices to consumers. We believe it is

critical that you urge U.S. regulators to continue working closely with their foreign counterparts and move quickly to recognize equivalency and substituted compliance with foreign regulatory regimes when the objectives of foreign regulations are comparable to those under the Dodd-Frank Act and where foreign regulations do not unduly burden U.S. end-users.

Commodity Derivatives to Hedge End-Users' Commodity Price Risks

End-users are subject to the risks of changing prices for such items as commodity inputs to their manufacturing processes and energy consumed in manufacturing their final products. To hedge these exposures, they prefer to arrange properly constructed commodity derivatives contracts with one of their banks. The Federal Reserve Board proposes to issue a final rule imposing limitations and restrictions on the physical commodity activities of the financial holding companies it regulates. Among other things, it would make physical commodities trading by financial holding companies more expensive by imposing up to a 1,250% risk weighting, even on some physical commodities that are widely traded such as oil and certain other petroleum-based products. NACT is concerned that:

- Financial holding companies already are being forced to exit the physical commodity markets and end-users that rely on bank counterparties for physical commodities transactions are having to find substitutes that can be less creditworthy and less strictly regulated than their banks
- The exit of banks from these markets brings about reduced liquidity resulting in higher costs from less competition
- New documentation is being required that is less credit efficient in the sharing of risks among counterparties, also bringing higher costs

End-Users and Money Market Mutual Funds

There is no question that liquidity is the lifeblood of any business. Without having ample liquidity, production comes to halt, inventories run low, and bills are not paid on time. The cyclical nature of many businesses places significant importance on the availability of committed financing so that they can operate efficiently and without disruption. To illustrate the interconnectivities between end-users and the financial markets, it is useful to consider their use of money market mutual funds ("MMMFs"). This has been a market of more than US$2.5 trillion not only selling short-term investments to handle treasurers' temporary excess cash, but on the other side, buying the commercial paper corporate treasurers issue to finance the day-to-day funding needs of their companies. However, in September 2008 the Primary Fund of the Reserve Fund group of mutual funds "broke the buck" when it reported a net asset value per share that rounded to less than a dollar.[3] In the period since the financial crisis, regulators have sought new rules for MMMFs to strengthen the market during times of financial stress. MMMFs had always operated with fixed net asset values ("NAV") with a price per share greater than

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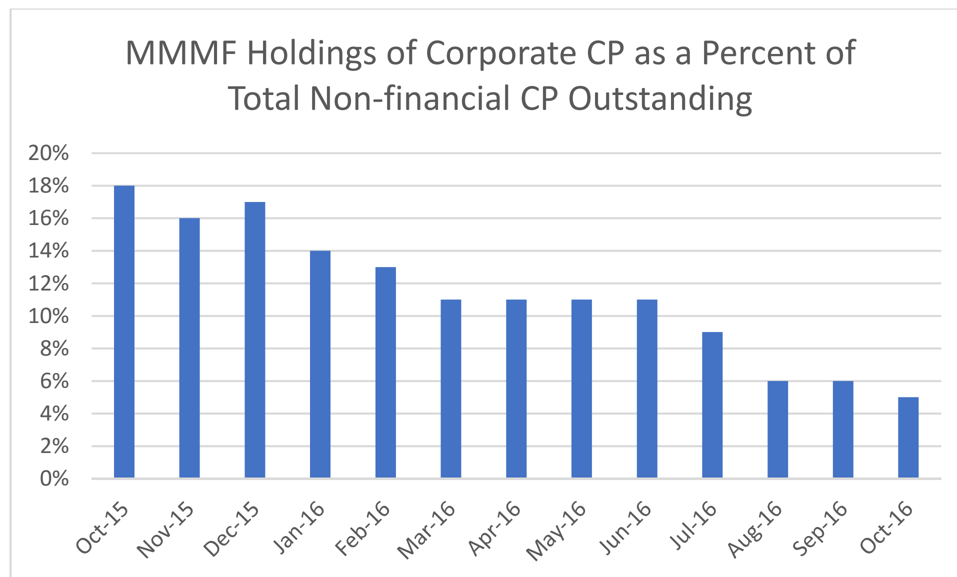
[3] The New York Times, Dealbook, September 7, 2008, "Money-Market Fund 'Breaks the Buck'"

US$0.995 and less than US$1.005, so that the NAV rounded to the nearest cent was one dollar per share.

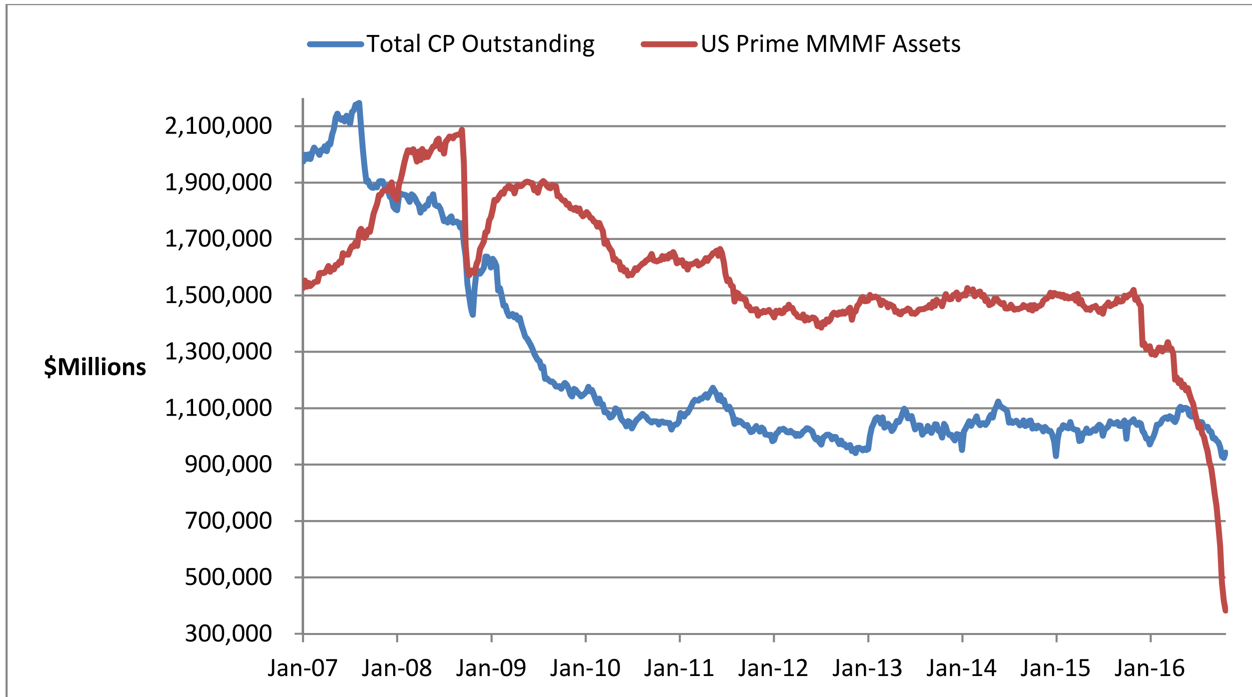
Congress felt it unnecessary to include additional reforms for MMMFs in the Dodd-Frank Act as the SEC had already enhanced regulations under its Rule 2a-7 changes in 2010. However, additional changes went into effect on October 14, 2016 that impose liquidity fees and redemption gates to spring up during periods of market stress. A requirement for a prime fund's NAV to float and be reported to the nearest hundredth of a cent significantly complicates investments in prime funds for corporate treasurers. The floating NAV requirement does not apply to MMMFs investing in government securities, however.

The practical implications of the new rules are daunting for corporate treasurers. Corporate treasury and financial reporting systems up until now have treated fixed NAV MMMFs as cash equivalents. Now MMMF shares in non-government funds will have a floating NAV per share that must be tracked essentially in real time. For federal and state income tax purposes, a floating NAV requires treasurers to keep track of gains and losses when they inevitably buy MMMF shares at one price and sell them at another in the routine redemption of their investment. Since treasury systems must compete with other departments for internal IT resources, the question of what alternatives are available must be answered. Corporate treasurers can abandon the prime MMMF market and instead invest in government MMMFs that can retain the dollar per share fixed NAV. However, prime funds are important to treasurers not only as a flexible alternative for investments of temporary excess cash balances, but also as providers of short-term funding by buying corporate CP notes. As the graph below shows, in the year running up to the October 14, 2016 implementation of the new regulations, fund purchases of corporate CP declined significantly.



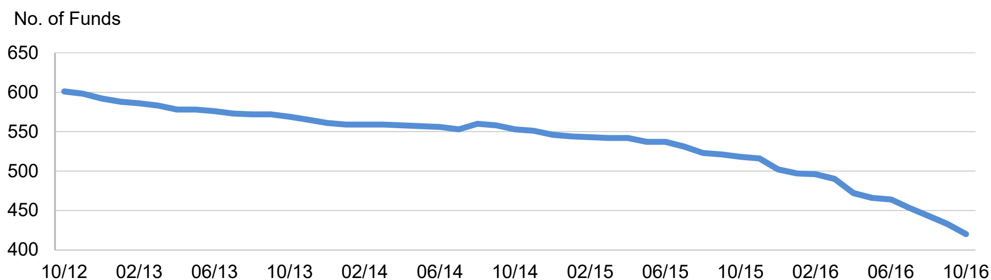
Source: Fitch Ratings and Crane Data

Concerns about investors fleeing prime MMMFs have indeed proven true, declining by US$1 trillion to US$376 billion since the rule became final (see chart below).



Source: Federal Reserve, iMoneyNet, Fitch Ratings

The cure proved worse than the disease for many fund managers as they closed almost 200 institutional prime funds (see chart below).



Source: SEC

The cumulative effect of the regulatory changes on MMMFs caused US$1 trillion to leave prime funds with much of that moving to government funds unaffected by all the same rules. Corporate treasury investors in these funds were unable to justify or implement quickly enough changes to their treasury and financial reporting systems required by the new rules. End-user companies were adversely affected not only through fewer choices for the investment of their cash, but for many, an uptick in CP borrowing costs as an important investor base went away.

Summary

A bipartisan consensus in the last Congress confirmed that 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, which would have diverted these funds from investments to build inventories for higher sales, conduct research and development activities, expand plant and equipment, and ultimately grow jobs. However, the imposition of additional capital requirements by the Prudential Banking Regulators on financial institutions acting both as derivatives counterparties and lenders to end-users would undermine this intent by forcing banks to hold much more of their own capital in reserve against end-users' derivatives and borrowing positions, passing on these increased costs to end-users and ultimately their customers.

The cumulative effect of new derivatives regulation threatens to impose undue burdens on end-users. The indirect effects of this 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. There are also several adverse effects on end-users' funding costs from the way certain bank capital requirements are applied. We urge you to direct financial regulators to conduct a study of major regulatory initiatives for cumulative impacts on end-users directly and indirectly through financial institutions. Many NACT members participated in a recent survey by the U.S. Chamber of Commerce, which underscores the need to examine our financial services regulatory structure. The Chamber's report, *Financing Growth: The Impact of Financial Regulation*, asked more than 300 corporate finance professionals, including CFOs and treasurers, to report on the impact of financial services regulatory reform on the availability and cost of the products and services most crucial to the growth of Main Street businesses.

One key finding from the report includes the fact that access to credit remains their top concern. However, more than three-quarters of American companies of all sizes believe that the cumulative effect of financial regulations adopted over the past six years is making it harder for them to access the financial services they need. In addition, 79% of respondents indicate that they are affected by changes in financial services regulation, resulting in 39% of respondents absorbing higher costs and 19% delaying or cancelling planned investments.

We need a regulatory system that allows Main Street companies to use the financial system to hedge day-to-day commercial risks, securely manage their cash flows, fund their businesses in the most cost-effective way, and play on a level field with their foreign competitors. By having a regulatory system that allows businesses to improve their planning and forecasting, manage unforeseen and uncontrollable events, offer more stable prices to consumers, end-users can more readily contribute to economic growth.

End-users are using the financial system to mitigate the business risks they face in their day-to-day business activities. In this respect, they are fundamentally different from financial companies who maintain an open book of exposures and who seek profit through properly structured speculative positions. However, when rules intended to apply to financial institutions 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 investment and undermines our ability to meet and beat international competition, leading to material adverse cumulative impacts on corporate end-users, American workers, and our economy.

The consequences of getting the right balance in the regulation of our financial system will benefit American business, our customers and our workers.

Thank you. I will do my best to address any questions you may have.