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REFORMING U.S. FINANCIAL MARKET REGULATION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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CONTENTS

Page

HEARING(S):

Reforming U.S. Financial Market Regulation 1

Wednesday, November 18, 2009

STATEMENTS PRESENTED BY SENATORS

Lincoln, Hon. Blanche L., U.S. Senator from the State of Arkansas, Chairman, Committee on Agriculture, Nutrition, and Forestry 1
Chambliss, Hon. Saxby, U.S. Senator from the State of Georgia 3

Panel I

Gensler, Hon. Gary, Chairman, Commodity Futures Trading Commission, Washington, DC 5

Panel II

Billings, Jeff, Manager of Risk Management, Municipal Gas Authority of Georgia, on behalf of the American Public Gas Association, Kennesaw, Georgia 35
Boling, Mark, Executive Vice President and General Counsel, Southwestern Energy Company, Houston, Texas 32
English, Glenn, Chief Executive Officer, National Rural Electric Cooperatives Association, Arlington, Virginia 28
Johnson, Robert A., Director of Economic Policy, The Roosevelt Institute, on behalf of Americans for Financial Reform, New York, New York 36
Schloss, Neil M., Vice President And Treasurer, Ford Motor Company, Dearborn, Michigan 30

APPENDIX

PREPARED STATEMENTS:
- Nelson, Hon. E. Benjamin 52
- Billings, Jeff 54
- Boling, Mark (with attachments) 65
- English, Glenn 75
- Gensler, Hon. Gary 79
- Johnson, Robert A. 90
- Schloss, Neil M. 122

DOCUMENT(S) SUBMITTED FOR THE RECORD:
- Joint Association Statement on Proposed Reform of Over-The-Counter Derivatives Markets 128

QUESTION AND ANSWER:

Lincoln, Hon. Blanche L.:
- Written questions for and responses from Jeff Billings 134
- Written questions for and responses from Mark Boling 136
- Written questions for and responses from Glenn English 142
- Written questions for and responses from Gary Gensler 144
- Written questions for and responses from Neil M. Schloss 152

Conrad, Hon. Kent:
- Written questions for and responses from Gary Gensler 147

Page

Klobuchar, Hon. Amy:
Written questions for and responses from Gary Gensler 150
Stabenow, Hon. Debbie:
Written questions for and responses from Gary Gensler 148
Written questions for and responses from Neil M. Schloss 152

REFORMING U.S. FINANCIAL MARKET REGULATION

Wednesday, November 18, 2009

UNITED STATES SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC

The committee met, pursuant to notice, at 9:36 a.m., in Room 106 Dirksen Senate Office Building, Hon. Blanche Lincoln, Chairman of the committee, presiding.

Present or submitting a statement: Senators Lincoln, Conrad, Stabenow, Nelson, Casey, Gillibrand, Chambliss, Lugar, Cochran, Johanns, Grassley, and Thune.

STATEMENT OF HON. BLANCHE L. LINCOLN, U.S. SENATOR FROM THE STATE OF ARKANSAS, CHAIRMAN, COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Chairman LINCOLN. The Senate Committee on Agriculture, Nutrition, and Forestry will now come to order.

I want to thank Senator Chambliss and fellow members of the committee for being here today as we address one of the more important issues facing our nation and particularly our economy. I cannot overstate the significance of the subject matter of our hearing today. Financial market oversight reform is, quite simply, the single most important factor in our long-term economic recovery. It will be the foundation for our nation's financial future, and reform is essential to reaffirm the integrity and the soundness of our financial system and to maintain our nation's preeminence as a global leader in worldwide financial markets. Perhaps most importantly, we need financial reform to give comfort to our consumers and the businesses so that they can trust our markets to determine fair prices and to help manage risk.

Over the last decade, we have seen deregulation sweep over America in a way that has simply devastated our economy. From the tragedy of the Enron bankruptcy in 2002 to the massive failures of Bear Stearns and AIG in 2008, a steady stream of market calamities has exposed fatal flaws in our regulatory system. These flaws have cost America dearly.

And given this reality, business as usual is simply not acceptable. Fundamental financial market oversight reforms must pass. It is important to remember that while we must correct mistakes of the past, we do not want to overreact or veer too far in the other direction. We have a very difficult needle to thread here, but we are certainly all very capable of it. We have no desire to, nor will

we, act in a way that will prevent legitimate business activity or stifle innovation.

But the word "innovation" cannot be a code word for unacceptable practices. Smoke-and-mirrors accounting schemes, massively leveraged by under- or non-capitalized transactions, or house-of-cards entities posing as investment vehicles are not the kind of innovation that prudent financial market oversight should foster. We can do better and we will.

The task that is set before us is considerable, but it is not impossible. It is difficult, but it is not unattainable. It will be at times confusing, but the answers really are not impenetrable. We will get it done.

Senator Chambliss and I intend to work together to produce legislation that will bring much-needed transparency and accountability to the over-the-counter derivatives market. In our legislation, I am looking to address issues such as prudential regulation related to enhanced capital and margin requirements, clearing of over-the-counter transactions, as well as a host of other matters, including forex trading and foreign boards of trade. The list is long, but we will get there.

And I look forward to hearing from all of the interested participants, getting their views and cultivating a healthy debate on this topic. Today, we will focus specifically on three areas: End user margin and clearing, the definition of major swap participants, and mandatory clearing of standardized products.

I particularly look forward to today's testimony from end users. Knowing the importance of cash flow and working capital to businesses, I will be paying great attention to what they say about clearing requirements and margin as I will to how we address systemic risk.

On December 2, we plan to hold a second hearing, at which Treasury Secretary Geithner will testify, and we will further analyze these and other issues. I look forward to hearing views from all sides on these very important matters to all Americans.

Lastly, I want to commend Senator Dodd for the draft legislation he released last week and its comprehensive view of the nation's banking oversight system. There are areas of mutual interest in financial market oversight, and I look forward to working cooperatively with him and his committee as we move forward.

There is a lot of work to be done, but I know that we will pass reform legislation that truly does build something better. We owe that to America's consumers and businesses, and they deserve no less than our very best efforts to ensure that the U.S. financial oversight system promotes and fosters the most honest, open, and reliable financial markets in the world. It is our responsibility as Americans to be leaders in this direction.

Thank you all for your time today. I look forward to hearing from our witnesses and from my colleagues as we move forward to reach this goal. And as I said before, it may not be easy, but we can do it and we will.

So thank you all for being here today. I will turn to my friend and colleague, Senator Chambliss, for his opening statements and then we will return to our witness.

STATEMENT OF HON. SAXBY CHAMBLISS, U.S. SENATOR FROM THE STATE OF GEORGIA

Senator CHAMBLISS. Well, thank you, Madam Chairman, first of all, for your leadership on this issue and in particular for holding this hearing today.

As you and I have discussed previously, we both strongly believe that the Senate Agriculture Committee and the Commodity Futures Trading Commission must be engaged in the development of any legislation addressing financial regulatory reform. This committee also has a responsibility to ensure that the CFTC continues to be able to effectively carry out its duties, and that is why I am really pleased that we have once again Chairman Gensler back with us to talk about not only the complexities of the issues, but the practicalities of where we need to go with respect to regulatory reform.

While this issue is complicated, we cannot let the complexity of futures and swaps be an excuse for ignoring good public policy and ensuring that our markets are both safe and functional.

In the past couple of years, a lot of people have become acquainted with one particular type of derivative known as a credit default swap, or CDS, which permits one party to transfer the credit risk of bonds or syndicated bank loans to another party. Since AIG was heavily involved in CDS, it seems simple enough to just blame swaps in general for the current financial crisis. However, that would be inaccurate, because the real situation is much more complicated.

We need to distinguish between credit default swaps and the actual underlying securities represented by these swaps. Before we make a big policy change, like an outright ban on all over-the-counter derivatives or a requirement that these products only trade on an exchange, we need to ask ourselves whether this will even address the underlying problem. Why take a chance in these uncertain times to make legislative and regulatory changes that could possibly make things worse, potentially dry up more capital and force the cost of doing business higher?

This does not mean that there isn't room for improvement. I think the volatility that we have seen over the past year in some markets warrants extensive analysis and some regulatory changes. And while I may have concerns with some of the proposals that have been discussed to date, I am absolutely convinced that the market volatility and financial meltdown of the recent past make the case for more market transparency.

How can we in Congress be sure of the outcome of sweeping reforms without first properly identifying the cause of these problems? And how can we identify the cause of the problem without authorizing and requiring more transparency through the collection of necessary data? Beyond requiring more transparency, I also believe this committee should explore how most effectively to regulate swaps, some of which are statutorily excluded from CFTC regulation and oversight. And we need to determine how best to encourage the clearing of certain derivative products without jeopardizing either the use of these risk management tools or the sustainability of our clearinghouses.

If Congress is truly interested in addressing the problem as opposed to politicizing a solution, we can no longer ignore the complexities of these markets. We must devote time to understanding these instruments and their applications. We must seek to understand the legitimate purposes that these complex instruments serve for large and small businesses in each of our States. That is why this hearing is so critically important.

I want to raise one final concern about financial regulatory reform. I would hope that as this legislation progresses through Congress, we will take whatever steps are necessary to ensure that it does not conflict with the Farm Credit Act and that it does not inadvertently hamstring the Farm Credit Administration and the entities that it regulates, the Farm Credit System and Farmer Mac. We know that the Farm Credit System and Farmer Mac did not cause or contribute to last year's financial crisis and that they have done a good job fulfilling their Congressionally mandated mission of providing competitive credit to farmers, ranchers, and rural America.

We can thank our colleagues on this committee and the House Agriculture Committee for their insight and leadership years ago in establishing these entities and providing for a strong regulatory system through the Farm Credit Administration. I look forward to working with the Chairman and all of our colleagues on the Banking Committee to make sure the financial regulatory package does not negatively effect the Farm Credit Administration.

Again, to my friend, the Chairman, thanks for holding this hearing. I know that it is a beginning of a process that recognizes the role of the Senate Agriculture Committee in broader financial regulatory reform efforts and I look forward, as always, to working side-by-side with you. Thank you very much.

Chairman LINCOLN. Thank you, Senator Chambliss, and I, as always, look forward to working with you. I think we have got a great opportunity to find a good outcome and really be productive for the people of this country and certainly the marketplace, which we want them to have greater confidence in, and we can do that from here.

I would also like to echo the comments of my colleague, Senator Chambliss, on the Farm Credit Administration and the importance of recognizing that there is not a necessity here in any way or shape or form to try to put them into a position where they are hamstrung or not able to continue to do the good work that they have done, so I appreciate his comments there.

We would now like to welcome Chairman Gary Gensler to the committee. Chairman Gensler, welcome once again to the committee. We are proud that you are here and looking forward to working with you on this tremendously important issue as we move forward and working through the details of how we put our markets and our economy back on track. I know you have got a great insight into this in your work from multiple different areas where you come. And I am also usually relieved because I know that when the day has ended, that you usually get your marching orders from four lovely ladies at home.

So we appreciate how you are grounded and, more importantly, how you are working hard to make sure that we get this right. So

we look forward to your testimony today, and welcome to the committee.

STATEMENT OF HON. GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Mr. GENSLER. I thank you, Chairman Lincoln. I will mention to my three daughters your hello. And Ranking Member Chambliss and members of this committee, thank you for inviting me to testify on behalf of the full Commission today regarding regulation of over-the-counter derivatives markets and, if I am allowed, I am going to say a comment or two at the end about our joint efforts with the SEC on some harmonization efforts.

But before I begin, I would really like to congratulate the new Chairman, Chairman Lincoln. I think this is the first time I am testifying before you as Chair. I want to thank Senator Harkin for his leadership of this committee and I look forward to working with all of you going forward.

I would like to address regulation of the over-the- counter derivatives market in the context of two principal goals that I think there is a broad consensus around. One is promoting transparency of the markets, and two, lowering risk of these markets to the American public.

In terms of transparency, the administration proposed and I fully support the following priorities. First, that all standardized derivative transactions should be moved onto regulated exchanges or transparent trade execution facilities, similar to what we have in the securities or futures markets. Increasing transparency for the standardized derivatives should enable both large and small end users to obtain better pricing on their derivative products. Just as transactions are on the securities markets and the futures markets available and you can see trade by trade what occurs there, and every corporate treasurer, assistant treasurer, or municipal government can see the transactions, we believe that same transparency will help benefit growth in America and promote market efficiency in America.

If Congress were to exempt some end users—and I know you have a panel of end users you are going to be chatting with—exempt end user transactions from a clearing requirement, I think that—and I believe that those transactions could still be required to be brought onto the trading platform—a trade is where buyers and sellers meet— and still exempt them and separate out from the clearing requirement where there is this issue of posting margin that I know you will be talking about.

Second, I believe all non-cleared transactions—these are the customized transactions which should still be allowed—should be reported to a trade repository so that the regulators can at least see those transactions.

Third, data on the transactions themselves should be aggregated and made available to the public in an aggregate form, for both the customized and the standardized products.

And fourth, stringent recordkeeping and reporting requirements should be required for the swap dealers with an audit trail so that we can effectively look into these markets even after the fact.

The administration has proposed, and at the CFTC we support lowering risk for American public. Again, I will talk about four principal components. First, standard over-the-counter derivatives transactions should be required to be cleared on a robustly regulated central clearinghouse. By guaranteeing the performance of these contracts submitted for clearing, clearing significantly reduces systemic risk. Clearinghouses significantly reduce systemic risk by removing the interconnectedness in this marketplace.

I believe that all clearable transactions should be required to be brought into clearinghouses regardless of the end user, but if Congress were to decide to exempt transactions for certain end users, I would hope that would be narrowed to the corporate end users and it wouldn't exempt transactions, for instance, with hedge funds and other financial investment funds. I think there is a difference in the needs of those. Also, I would hope we would still bring them into the trading requirement and exempt them from the margin or the clearing requirement.

Second, swap dealers and major swap participants would be explicitly regulated for capital, so they have a cushion against risk.

Third, the dealers would be required to post margin themselves. This would be the dealers posting margin, not the end users in this case.

And fourth, the CFTC and SEC should be authorized to mandate robust business conduct standards to protect the marketplace against fraud, manipulation, and even aggregation position limits for the commodity space in this marketplace.

If I might just take a moment to say, we have been working with the SEC to harmonize some of our rules. We are different agencies. We have different missions, but we have a lot of overlap. We have actually put together a report the President requested with 20 recommendations, 11 of which will require legislative assistance from this committee and the rest of Congress. Some of them are in the administration proposal we have already sent up. I just wanted to highlight in my 15 seconds left two, really quickly.

One is I do believe with the significant risks that are in these clearinghouses, both futures clearinghouses, and new swap clearinghouses, that it is appropriate to look back to our oversight, the CFTC's oversight, of clearinghouses, bring some of the core principles that have worked well to international standards, and ensure that in certain circumstances that the CFTC has a little bit more authority to write rules. This was included in the administration's proposal and we have been working with the exchanges directly on some of that language.

Second, we have found that our ability to enforce the markets and protect them against manipulations can be enhanced, and we have legislative language that we will be sharing with this committee on specific disruptive trading practices that we think it would be appropriate to try to enhance our ability to police these markets for manipulation.

Again, we will be working with this committee on the other nine recommendations that need legislative assistance and I have included that in my written testimony. I look forward to working with this committee and Congress to bring this much-needed reform to the over-the-counter derivatives marketplace.

[The prepared statement of Mr. Gensler can be found on page 79 in the appendix.]

Chairman LINCOLN. Thank you, Chairman Gensler. I appreciate your comments here today and am looking forward to working with you.

I will start with my questions and then turn to my colleague, Senator Chambliss, and then we will go in the order that people arrived to the hearing.

Chairman Gensler, it's my understanding that the more standardized a product is, the easier it should be or would be to clear and exchange trade, and that clearing and exchange trading are in some ways gold standard of risk management in the derivatives world. Given that, I do believe that moving as many of these contracts as we can through a clearinghouse or onto that regulated exchange is important. But I also believe there is a place for tailored contracts and some over-the-counter market transactions.

My question is really who should make the determination as to what is standardized and should be cleared? Should it be the clearinghouse or should it be the regulator? If it is the clearinghouse, in my opinion, that does look to be somewhat of a—I don't know. There is some concern there. My question to you is if, in fact, the clearinghouse was asked to do the clearing determination, what safeguards would need to be there and what is your position on who should make that determination?

Mr. GENSLER. I——

Chairman LINCOLN. Maybe you could also mention some of your response to Chairman Frank. I know that there was a back-and-forth on that, as well.

Mr. GENSLER. Sure. I recall the first time I was in this committee room on February 25 for my confirmation hearing. This very question came up with then-Chairman Harkin. I believe that the regulators, the SEC and the CFTC, should have clear authority to determine that contracts are standard enough to be cleared. I believe we should also be able to rely on market mechanisms, that there is some presumption that if a clearinghouse were to accept it for clearing, that we should be able to hopefully rely on that, and the presumption is to get as many transactions and as many contracts to be cleared, and hopefully on these transparent trading venues.

So to answer your question, I think the regulators should have clear authority to make the determination, but also be able to rely on some market mechanisms that the clearinghouses might, in fact, determine something is clearable, but we could add to that list and we would have to approve—to have a safeguard against the clearinghouse, we should also approve which transactions are clearable, hopefully by class of transaction just for efficiency. But in certain circumstances, we would do it contract by contract.

Chairman LINCOLN. But to make sure I understand what you are saying, you are saying that should be predetermined?

Mr. GENSLER. I think that it should be transparent. The marketplace should clearly know if they are entering a transaction—if an end user is entering into a transaction, they should know, is this one that has already been designated by the regulators and the clearinghouse to be, quote, "standard" or clearable, and I do be-

lieve, thus, it should be transparent, and as you say, predetermined, and that the clearinghouses have a role to play, but the regulators should have clear authority to make a determination.

Chairman LINCOLN. Thank you.

A major swap participant is defined in the Treasury proposal as a non-dealer who maintains a substantial net position in outstanding swaps for the purpose other than to create and maintain an effective hedge, under the GAAP standards. I understand that some of the players want a limited definition of the MSP so as to not to kind of get pulled into that category, perhaps. Maybe there is reason for that for some, and for some, maybe there is not.

Are you comfortable with the Treasury's definition of major swap participant? Are the GAAP standards the appropriate standard to determine hedging, and if not, what is? Is a substantial net position standard workable and is it going to capture all the institutions that pose the kind of systemic risk that we are trying to get at?

Mr. GENSLER. What we are trying to do in the legislation is ensure that there are two complementary regimes, that the dealers are regulated, they have to register and be regulated, have capital and business conduct standards, and then that the markets themselves have these clearing and trading requirements.

Major swap participant is a term that nine months ago none of us knew. It was just created in the legislative language. But what it is really trying to address is the next AIG or the near-dealer, something that is not quite a financial institution, but it holds itself out to the public, as a substantial net swaps business. There are many counterparties that would be at risk if it failed. I don't know its broad category. It is not meant to pick up the thousands of end users or even the hundreds of end users. But I believe it should be a category that is included, that we not just bring this regulation to the five or six large financial institutions. They are sort of the next AIG or the next swap dealer category.

Chairman LINCOLN. Well, depending on what standards are going to be used to determine that, as an alternative, I mean, when you are looking for Congress to be helpful, could Congress use a gross notional exposure standard to determine who is going to register as a major swap participant, and if a gross notional exposure test is appropriate, what should the level be?

Mr. GENSLER. I would want to work with you and the committee to see if that would be appropriate. I think, most importantly, is that the full registration and regulation would be of swap dealers and the next, I don't know if it is several dozen, but the next several that really hold themselves out to the public as almost like a swap dealer and have a significant book of business with a lot of counterparties. And so I think it is more with regard to do they have other end users as counterparties as contrasted to are they just doing their business with Wall Street, would be the best test.

And again, that is separate and apart from these issues of whether end users post margin or whether end user transactions are brought to trading venues. We should try to bring as many of these end user transactions into transparency.

Chairman LINCOLN. Well, I mean, obviously, if we are working toward something that is going to provide more oversight and regu-

lation, then standardization and what we use to standardize is going to be a key question. So we look forward to working with you on that as I definitely think that is going to be important, to have something more definitive about what that standard is going to be.

And I have gone over my time, so I am going to wait for my second round and I will defer to my colleague, Senator Chambliss.

Senator CHAMBLISS. Mr. Chairman, I guess if we could write down on paper very clearly what is standard and what is not standard, it would make our job a lot easier, and certainly that is something we are going to continue to wrestle with and work with you on.

I want to, first of all, ask you a very practical question. We have got a very valued member of this committee who is here who also happens to be Chairman of the Budget Committee. As he moves forward next year, irrespective of what we do, we have got to have a clear picture of what it is going to cost. Part of the cost obviously is increasing the resources to CFTC to make sure that the new challenges that we give you, you are obviously capable of carrying out.

CBO indicated that the House legislation would require an additional 235 employees by 2011 for CFTC—that is a 40 percent increase—resulting in an increased cost of $291 million over the next five years. Your agency's total appropriation for fiscal year 2009 was only $146 million. How will you implement these changes that are set forth in the House bill, for example, if you do not get the necessary increases in appropriations?

Mr. GENSLER. Well, I thank you, Senator. I think our agency, unfortunately, has been sorely under-resourced for a number of years. With Congress's help, we are just now back to the same staffing we were at in 1999, and that is even though the markets have grown at least four-fold and we have not yet even taken on this new authority, over what is nearly a $300 trillion market. The swaps market is roughly, in notional amount, 20 times our economy. So that means every time you buy a tank of gas, you can think of about $1,000 of derivatives behind that $50 tank of gas, somewhere, on average, in the economy.

So in staffing, we do believe that we would need probably in the order of magnitude, 235 people to add to the approximate 2010 staffing level of about 650 people.

Senator CHAMBLISS. Okay. Many end users of derivatives have informed us that they do not believe that the benefit of clearing is worth the expense of posting margin at a clearinghouse, and we have talked through this time and time again. You have proposed that clearing members of a clearinghouse, such as financial institutions, could post margin to the clearinghouse for their end user counterparties who would then meet collateral requirements through credit arrangements involving non-cash collateral.

I want you to help us think through this and help us understand how this would work with respect to daily margin settlement. What sort of expense do you believe these end users would incur in the form of fees or variation margin charges if, as you have proposed, their dealers were posting margin to the clearinghouse on their behalf?

Mr. GENSLER. The goal, I think, is to lower risk in the system and to move as much of these transactions off the books of the financial institutions once they have arranged them, and that is where the clearinghouse comes into place because it is safer than the financial institutions. No matter what we do in financial reform, financial institutions still, I believe, are going to be very large, complex, and they will house risk. That is their business.

So if we can move these transactions in the clearinghouse, allow end users, just as they do now, to have individual credit arrangements, maybe unsecured or secured arrangements with the banks and have the banks move them to the clearinghouse and post the margin. Today, they are charged a credit arrangement. These swaps do have a credit fee in them.

End users have raised their concern it might still raise their costs. They recognize there is a credit arrangement already, but it might raise their costs, and I recognize Congress might decide to exempt them. I hope we would keep any exemptions narrow, just to the corporate end users, hopefully not to the financial end users like hedge funds that do have liquidity and could post margin.

Senator CHAMBLISS. One practical aspect of that that I have a problem with is, for example, Delta Airlines, who is a big user of this type of transaction, having to put up an airplane, a 777, for each transaction, or any other company taking part of their non-cash collateral that they normally would post for a line of credit and having to put it up as collateral of some sort for one of these type transactions. Again, I am not sure how we resolve that to make sure that we do lower that risk you are talking about, but don't hamstring these companies from not having the ability to post those non-cash collateral assets for lines of credit that they have got to have.

Mr. GENSLER. Well, actually, Senator, today, many large institutions—I am not familiar enough with Delta's own finances, but many large corporations have credit arrangements with the large Wall Street firms that say if we hedge a transaction and there is an exposure that develops six months or a year later, that they do have some arrangement. They might not be securing it with an airplane, but in some way, they are being charged for that credit arrangement. Even today, there is no free lunch there. There is a charge for the credit arrangement. It is just that they are not posting cash, and I don't think they need to post cash in the future.

Senator CHAMBLISS. Let me go to one other area that we have talked about before, and you know my concern regarding, making sure that we don't take any action from a legislative standpoint going forward that handicaps U.S. markets as competitors from the standpoint of individuals utilizing foreign markets to carry out the same type of transaction that they are doing today on U.S. markets, and that we don't overregulate them.

In your testimony and in previous discussions, we have talked about the fact that you want to make sure that any U.S. company that trades on foreign markets still provides CFTC with information regarding those transactions so that we can have total transparency, and I understand why that is absolutely necessary. If you have got somebody trading on a U.S. market and a foreign market, if we are going to be able to let the general public know the finan-

cial condition, obviously, you need to be aware of both those transactions, whether it is on foreign or U.S. market.

Give us your thoughts about your impressions on the, number one, ability of foreign markets to give you the right kind of information, and secondly, on the receptiveness that you have seen from foreign regulators regarding providing information to U.S. regulators, both SEC and CFTC.

Mr. GENSLER. I think that the crisis was so severe, both in Europe and in the United States and in Asia, that we do have a very good consensus. I am optimistic. I have worked in Europe, I have been over there and I have talked to the regulators almost on a weekly basis. They put out a paper about a month ago that said that they are going to be mandating that the standardized contracts be brought into transparent trading venues, just as we are considering here, mandating that the standard contracts be brought into central clearing, and they have also said that for the non- standard contract, they would be requiring the banks to hold higher capital. They actually used the word, I think, "significantly" higher capital.

Now, their legislative process is different. They will take this to the European Parliament next summer. So they are really watching very closely what the Senate and the House do here. But I am very optimistic that though different cultures, different political systems, we will come out about the same on this with Europe, and between Europe and the United States, that is over 80 percent of these markets, and I think Canada, Mexico, and Japan are likely to work with this, as well, along the way.

So I think you are absolutely right, Senator, but I am optimistic that we will be able to achieve consistent approaches.

On information sharing, we have been very clear. We just wouldn't want bank secrecy laws in another country to hold back that information.

Senator CHAMBLISS. Today, on certain oil contracts that are traded on the London Exchange, the London Exchange provides CFTC with certain information to help with that transparency. Is the information that you are getting today from the London Exchange on those contracts, for example, adequate to allow you to feel that there is total transparency with those customers?

Mr. GENSLER. It is the futures market, not swaps, but they have been very helpful. First, a year ago, they agreed to give us positions, and then two months ago, we negotiated further. Now they are giving us transaction data, as well.

Senator CHAMBLISS. And is that the type of cooperative effort that it is going to take from all foreign markets?

Mr. GENSLER. I believe it will, and as I said, I think I am optimistic that we will be able to see into their trading and trade repositories and vice-versa.

Senator CHAMBLISS. Thanks, Madam Chairman.

Chairman LINCOLN. Senator Stabenow?

Senator STABENOW. Thank you, Madam Chairman, and welcome, Chairman Gensler. It is great to see you again. Madam Chairman, I also want to thank you for inviting Neil Schloss, the Treasurer of Ford Motor Company, a great Michigan company, to testify on

a very important part of the discussion about end users. We welcome all of the others on the second panel, as well.

To follow up on what Senator Chambliss was talking about in terms of the international cooperation, it sounds like you believe that we can develop a system for regulating the futures markets internationally, that what is happening—am I hearing you right—is something that you believe will allow us to do that? One of my concerns is that without having an international regulatory regime for energy commodity futures and derivatives tradings and so on, that we are going to see companies that use derivatives to hedge legitimate business risks being placed at a competitive disadvantage, potentially, if we are not confident that we can do that.

So am I hearing you say that you are confident, and what else would you need from us to be able to support your effort to be able to make sure there is an international agreement that is good for our businesses?

Mr. GENSLER. I am optimistic. When the President met with 20 heads of State in Pittsburgh, I think now we are about two months ago, he was successful in negotiating these core principles right in the G–20 statement to ensure that we brought the standard part of the markets onto clearing and onto trading venues. It was at that high a level, at the G–20 included. And then the European Commission, as I said, followed up.

So I am confident. It won't be exactly the same. It is two different cultures and two different political systems. But I am confident, and I agree with you, Senator, that we need that.

I think it is important in the statutory language you pass here, if successful, that there be some recognition explicit authority for the Commodity Futures Trading Commission to register some foreign boards of trade. We have been using what is called a "no action" process, and I think that could be enhanced in statute. But I am confident overall that we will come close, maybe not exactly the same.

Senator STABENOW. All right. Thank you. You and I have talked about concerns about end users and the impact of whatever we do, and we know that 92 percent of the largest American companies and over 50 percent of mid-size companies use derivatives to hedge business risk. So whether it is hedging the business risks associated with oil prices, as has already been talked about, or currency exchanges, the ability to provide financial certainty to companies' balance sheets is absolutely critical for them and for us in terms of jobs and so on.

So I appreciate your comments and your efforts to protect end users from diverting needed capital by providing the option to post non-cash collateral to meet the clearing requirements. However, we are in a situation where we have many companies that can't use their non-cash collateral, such as a manufacturer who has a mortgage on a building because the mortgage agreement is preventing them from using it. I would dare say that anything right now that is viewed as non-cash collateral is taken, I would guess, for many, many of our manufacturers.

So that still raises a great concern to me. I know you spoke a moment ago about arrangements that already exist, but this is

very serious for our manufacturers and I wonder if you might speak to how you would handle that situation.

Mr. GENSLER. Well, I think that every manufacturer in your State and in all of the States suffered gravely when AIG went asunder and $180 billion of our taxpayer money, I mean, roughly $3.5 billion per State. I think in Michigan, it would be bigger because per person——

Senator STABENOW. Right.

Mr. GENSLER. You could do the calculation. And so that is the risk we are trying to protect again, that large financial institutions aren't so interconnected with the economy at large and that we try to move these transactions over to these well-regulated clearinghouses.

I do think that there is a competing public policy interest that you just raised about the posting of margin, and that is what Congress is debating, these two public policy interests. One is lowering the risk of these financial institutions, and two is the interface with the end users.

And that is why I truly believe we can also lower the cost to these end users by having every treasurer, every assistant treasurer being able to see on a screen where the transactions have traded. And so a manufacturer in Michigan would be able to see where a manufacturer in New York last traded and price and volume of the transactions. Even if Congress decides to exempt it from the clearing requirement, I think that would be just an unfettered good for manufacturers, to see the prices and the volumes of these transactions and have them—just as we do in securities markets.

Senator STABENOW. Mr. Chairman, I agree with you on transparency, that is critical, and we are working through how we balance minimizing the risk to businesses, to consumers, to all of us in our economy and at the same time not creating a situation where we are diverting working capital that is so critically needed right now for so many of our businesses. And so I look forward to working with you as we work our way through to find the right balance.

Thank you, Madam Chairman.

Chairman LINCOLN. Senator Gillibrand.

Senator GILLIBRAND. Thank you, Madam Chairwoman.

Today, we are going to hear from a number of our corporate end users on derivatives, and these companies obviously, as we have discussed already this morning, use derivatives on a daily basis to hedge risks that are an integral part of their daily risk and of their businesses.

As we look at the regulation of derivatives going forward, my question is, do you see a difference in the various sources of derivatives and their ultimate uses, and I will give you some examples. For example, would you see a difference in a futures contract for copper that might be used to hedge the future costs of a manufacturing company's basic materials, which is sort of what Senator Stabenow is concerned about, than, say, an instrument like a credit default swap, which might have a less obvious benefit and has recently shown to have a greater potential detriment to the financial system?

And just to boil that down a little bit, in the credit default swap market, we have two kinds. We have naked and we have covered. Naked means there is no underlying ownership of the assets that you are talking about. Covered is much more like an insurance policy. It is quite ironic that we heavily regulate gambling, which is like the naked variety, and we heavily regulate insurance, which is like the covered variety, but we don't regulate at all if it is called a credit default swap, which I think is what goes to your point, Mr. Gensler, about some of your concerns.

So if there is greater risk associated with a specific derivative class, should they be regulated in a different manner with significantly higher safeguards associated with that regulation? For example, if you are going to be in the CDS market, do you want higher capital requirements so it doesn't undermine what Senator Stabenow is trying to say for a manufacturer that is trying to offset the price of copper because that is an input for their business, vis-a-vis another financial firm that may be using CDSs because it is a great way to create capital or a great way to hedge risk in a different respect?

Mr. GENSLER. I think, Senator, you raise an excellent point. I believe the draft administration bill allows this, but if it doesn't, it would be a worthy enhancement, to make sure that business conduct standards, capital charges, and the like could be set by different class—in terms of capital, it would be the bank regulators largely setting capital, but that they might be able to set capital different by class of contract. Credit default swaps are event contracts. One day, you think it is only this, and the next day, it gaps out and has a far different value because of the default. So it might be worthy to have different capital charges as an event contract, as you say. So I do believe there may be differences.

On business conduct standards, the administration bill, I think, has a robust set of charges to the SEC and CFTC to write business conduct standards. Credit default swaps also have a very real interplay to the securities markets, with individual stocks and protecting against insider trading and manipulation. I believe it is there already, but we would look forward to working with you if you think there is more that needs to be in the administration proposal on business conduct standards.

Senator GILLIBRAND. Well, I was mostly just interested in your opinion, if you think that this is an important issue to analyze fully and make recommendations on or not.

Mr. GENSLER. I do think that there are unique qualities of each category of swaps. Interest rate and rate swaps are very different than energy swaps, for instance.

Senator GILLIBRAND. Right.

Mr. GENSLER. We have asked for authorities to set aggregate position limits across markets where they perform a significant price discovery function. I think that is important in the commodity space. It is not really applicable to interest rate, for instance.

Senator GILLIBRAND. Right.

Mr. GENSLER. Credit default swaps, I do think have unique circumstances, particularly the interplay that you mentioned to the securities market and to issuers.

Senator GILLIBRAND. Okay. Second area of inquiry: Has the CFTC examined the impacts of the reform proposals on small businesses and farmers who may not directly participate in the swaps market but may indirectly be utilizing derivative contracts through an intermediary? And an example of this is a greenhouse farmer may enter an agreement to receive natural gas at a certain rate through an intermediary, who in turn would then use a derivative contract with a supplier to lock in a fixed price for that gas. So my concern is what impact would these small businesses and farmers see from the proposals that are currently before Congress?

Mr. GENSLER. I believe, Senator, they would have a very real benefit. Right now, for many small businesses or small municipalities and nonprofits, when they use a derivative, they might just do one every two or three years. They often have to go out and hire a financial advisor, maybe pay $50,000 or $100,000 just for that advisor to give them advice. What do they do on this hedge, this important hedge for their business or hospital?

I think if we bring transparency all the treasurers and assistant treasurers can see the pricing, we are going to see that small businesses actually are benefited. That is where the biggest information deficit is, is small and medium-sized businesses.

Senator GILLIBRAND. Thank you. Thank you, Madam Chairwoman.

Chairman LINCOLN. Senator Conrad.

Senator CONRAD. Thank you, Chairman Lincoln, and thank you and welcome to the Chairmanship of the committee. We are delighted to have you as our leader and have great confidence in the skills that you will bring to this committee. We especially appreciated the leadership you provided in the last farm bill discussion, along with the Ranking Member, the current Ranking Member. We had a good team and we have got a lot of challenges ahead.

I think this is one of the most important hearings of the year. I remember very well, Senator, several years ago, Warren Buffet called derivatives a nuclear time bomb, and we saw the bomb go off. I will never forget as long as I live being called after one of our Group of Ten meetings, Senator Chambliss, being called to the Leader's office, and I got there and there were the leaders, Republican and Democrat, of Congress and the Chairman of the Federal Reserve and the Secretary of Treasury and they were telling us they were taking over AIG the next day. They weren't there to ask us, they were there to inform us. And they told us in no uncertain terms they believed if it was not done, there would be a global financial collapse. That is about as stark as anything can be.

So already, just on the AIG debacle, we have seen taxpayers saddled with $180 billion of debt. We must act to prevent that from ever happening again. I believe the administration proposals are important and balanced and a good beginning.

I do want to register skepticism about a super- regulator. After having served on this committee for 23 years, I am concerned that CFTC would be down the end of a long dark hallway at the SEC, and I don't think that is appropriate. I would be very concerned about them not having the knowledge of the commodities that CFTC oversees that have been in CFTC's jurisdiction and domain and, frankly, in the domain and jurisdiction of this committee. So

I do want to register skepticism on the notion of a super-regulator, but that is not what I want to ask you about, Chairman Gensler.

We have heard from several end users who will be testifying on the second panel that if they are forced to come up with additional capital to meet the clearing costs, the additional capital required of clearing costs, that would put them in a difficult situation. One thing I would like to understand is how much are we talking about in terms of clearing costs? Can you put in perspective what we would be talking about in terms of margin requirements in a clearing situation?

Mr. GENSLER. Senator, I first want to thank you for your comment and support for the Commodity Futures Trading Commission. I, too, have found great expertise in the building, great staff that knows the derivatives market. As you look to the broader financial reform and councils and powers that are possibly considered for other regulators, I think it is important that market regulators, the SEC, as well, stay as independent, vigorous protectors of the markets and investors.

In terms of the cost. You are correct. There is potentially a cost of the extension of credit. If somebody wants to hedge a risk, maybe they are hedging $100 million, a big risk, $100 million of oil delivery, on the first day, the prices haven't moved. But a month later, the prices have moved and the question is, do they have to post something for that valuation difference.

In the futures markets, one does that already. That is how futures have been regulated for 70-some years. In the swaps markets, it is all individually negotiated, and that is why I have used the same words—I have said, leave it individually negotiated between those end users and Wall Street. Allow them to do what they wish. Currently, there is some pricing in that credit arrangement. The end users have said they are concerned that if we require it, it might go up, and it is very hard to tell whether that is correct, whether that is one basis point in that example of $100 million.

In natural gas, I am told, a lot of these current swaps will charge as much as five cents a million cubic foot for the credit arrangement. We don't have transparency in these markets right now, so I don't have good statistics.

Senator CONRAD. All right. My time has expired, but I would just say to you, I think you will find a lot of allies on both sides of the aisle on this committee with respect to CFTC jurisdiction. It is critically important to commodities, and many of us represent commodity States, that the regulator understand commodities. So I think you will find strong allies on this committee.

Mr. GENSLER. I thank you.

Chairman LINCOLN. Thank you, Senator Conrad, and I don't know that I need to echo that, but I will, that this committee does, or at least many of us do believe that.

Senator Lugar.

Senator LUGAR. Chairman Gensler, a bipartisan financial crisis inquiry commission has been established to look at the whole crisis and derivatives. It is my understanding that they are to report their findings by December of 2010. Now, I remember a hearing in this committee held a year ago October by Senator Harkin, and we had excellent witnesses. They described at that point, and this is

a year or more ago, that mortgages had been issued by local bankers and they sold them on to higher levels. They sold them on, packaging and packaging. Finally, they got pretty big packages at certain levels in the financial community and they sought firms like AIG, as it was mentioned prominently in that hearing, to get insurance. They were describing the derivative process as one of trying to obtain insurance for whatever risk there might be in those large packages.

But then one witness intrigued us by saying that you could buy not only insurance, but you could also express opinions through derivatives. So we said, what is this, a public opinion poll? They said, not exactly, but nevertheless, if you still felt that you were not quite secure, you might bet on, for example, the failure of the banking system of Iceland, or Pakistan, or something of this variety. Some of these situations or opinions might come home and balance out your risks some more.

Now, this was startling to all of us, but nevertheless, whether opinions are being expressed in such extravagant ways in derivatives, the mortgage thing did catch people's attention. I have read reports, and maybe you could confirm this, that as many as 25 million mortgages were issued that were subprime quality or worse. There was large encouragement by the United States Government for much of this. Some of it came really through some of our government firms. Private firms were encouraged, and banks, likewise, to do the same thing. This may not be the entirety of the world crisis, but it is a very large part of it, and that is why this inquiry by this commission is important. They need to identify really what it is that we are looking at here.

At the end of the day, whether it was extravagance in terms of idealism by our government that everyone should own a house, even if they could not pay for it, and everyone ought to have a mortgage, and people tried to keep insuring this through various derivative instruments, it was a catastrophe. How do we prevent these kinds of excessive public sentiments? Is the transparency that might come through the legislation now, or with amendments that might be suggested by you, likely to solidify unwise decisions with regard to things like prime or subprime mortgages or other unusual loans or transactions? And what is meant when people called about the dark passages or the ideas that somehow there are sort of blacked out areas that those of us who are unsophisticated really don't know about and should not know about? Are all of these going to be uncovered? Will the transparency bring to light good transactions, and bad, transactions?

Can you make a general comment about how we avoid the crisis again and how we identify correctly what happened this time so at least we might correct through public policy some of those areas?

Mr. GENSLER. Senator, I think there are many causes of the crisis, but I think we could all agree that the over- the-counter derivatives marketplace was one of the factors—not the only factor. And in the marketplace, it is currently not regulated in Europe or here, or in Asia, so there is not transparency. But at the size that it is, and a notional amount nearly 20 times our economy, just to give it a whole size, there are many important and fundamental things it does—hedging, corporations hedging their risk, interest rate, oil

risks, and so forth. But there are, as you said, some event contracts, expressions of opinion, as you say.

I do think that transparency in this marketplace, if we could bring as much as possible onto regulated exchanges, would help market participants foremost, that they would see the pricing. As Senator Chambliss earlier said, it was to determine the fair prices and hedge risk. I think moving transactions will allow end users to do that, but also that regulators could see the pricing.

I think that we need to make sure that dealers have sufficient capital and that there are business conduct standards, and real rules of the road. It used to be, well, this is an institutional market. We don't need rules of the road because it is all big women and big men dealing with each other. And we are really saying, no, we need some business conduct standards here, as well.

Senator LUGAR. Well, I strongly favor the transparency that you are talking about. Likewise, I am cognizant of the costs that come with people who are using these markets. I think we must be thoughtful about this. The results of this catastrophe are really unparalleled, and the long term costs of this are going to be borne by our grandchildren. This is not just simply a business transaction proposition.

Now, I am hopeful that transparency, at least inclusion of as much of this, leads to better decision making, both by businesses and government. My fundamental question is this. Even after we know the score, how do we prevent mistakes? Is the transparency likely to bring these things to the fore?

Mr. GENSLER. I think it is a big component. It is not the only component, and that is why we, I believe, need to also lower risk in the four ways that I mentioned in my testimony, getting as many transactions into the clearinghouse, away from these concentrated financial institutions. I mean, we only have five, six, seven that are really large in this industry right now here in the United States, and the same number overseas. So they are, in a sense, too big and too interconnected to fail. So we move the transactions away and make sure they have sufficient capital, as well.

Senator LUGAR. And hopefully give you sufficient capital to be able to enforce whatever the situation is.

Mr. GENSLER. Well, yes, because our $147 million this past year is small compared to any one department—any one swaps department of a large Wall Street firm. It is billions of dollars of revenue and costs.

Senator LUGAR. Thank you. Thank you, Madam Chairman.

Chairman LINCOLN. Thank you, Senator Lugar.

Senator Cochran.

Senator COCHRAN. Madam Chairman, thank you.

One thing occurs to me, and that is what is the practical consequence of the changes the Obama administration is recommending that we make? What are the practical consequences? I know we have another panel that will come along and tell about how they use the markets to transact their business and to market what they sell and finance the transactions that they have to make to be successful in the marketplace. From your standpoint, though, are they wrong when they say that the Obama administration's proposals are going to cost more? Isn't that going to be passed on

to consumers, like people who borrow money to buy cars or whatever, or businesses who use airplanes? Are the operational costs going to go up? What is your reaction?

Mr. GENSLER. I think the practical effect of the administration proposal, which I do fully support, is to lower the risk to the American public. Now, lowering the risk of these large financial institutions, which I think in some regards were mispricing liquidity, mispricing their capital, and had too little capital, could well take some leverage out of the system, some risk out of the system. And when you do that, they may well pass on costs. But I don't believe there is any free lunch, that the financial firms did get too highly leveraged and too much debt and through derivatives were possibly extending too easy credit, so to speak.

So I do believe that the end users would be able to hedge their risk. They would be able to tailor products. We are fully supportive that they could customize products. I do believe they would get lower execution costs by the transparency initiative, and where the real sort of rubber meets the road is whether they are included in this clearing requirement, which it may well be that Congress decides not to require that, and that is the balancing act that Congress is looking at.

Senator COCHRAN. Thank you. Thanks, Madam Chair.

Chairman LINCOLN. Senator Johanns.

Senator JOHANNS. Madam Chairman, thank you.

Mr. Chairman, it is good to see you. I want to start out and tell you how much I appreciate you taking the time to get around and stop by our offices. I think that is a very decent thing to do and very, very helpful in kind of thinking through some of these issues.

I think you have a committee here that kind of approaches this and recognizes the obvious need to do some things here, but I think we also recognize that, done wrong, this has some very, very serious consequences even for farmers in North Dakota or Nebraska in terms of how they manage their risk and a whole host of other people, not to just mention the agriculture community.

And I have some concerns here, I must admit. There is never time to go into all the concerns, so I am going to try to jump into a couple of things that just kind of jump out at me every time I think about this.

The first concern is, to be very candid with you, this reminds me a little bit of the climate change legislation. In theory, we can all agree about its merits and what it might be doing, but in reality, if you don't get the world on board, you are not going to get very far.

Now, if I were a small country out there, recognizing that just by its nature derivative trading is an international phenomena—I mean, we are trading in oil and commodities that sell in the international marketplace and hedging risk, et cetera—just by its nature, if I were a president of a small country out there, I would wait for the rest of the world to pressure down the regulatory atmosphere for the business community, and then I would find the sweet spots and I would do something different and I would gather all the business. What is going to stop that from happening?

Mr. GENSLER. Well, I think, Senator, that you are right that capital and risk know no geographic boundary or border. But I am op-

timistic, having worked closely with the Europeans and some of the other North American regulators, that we are going to come out with a consistent framework. There is still a lot in front of us, in front of this Congress, in front of the European Parliament. And I think these are the major centers of capital. So if we regulate our derivative dealers and the Europeans regulate theirs and we ensure through legislation that they can only have access to U.S. customers if they are comparably regulated, consistently and comparably regulated, I think that goes a far way.

That hypothetical that you mentioned always gnaws at us and we have to find ways to close that. But that small country that you mentioned wouldn't have the capital, wouldn't have the end users in that country.

Senator JOHANNS. But it might be able to attract it through its sympathetic regulatory atmosphere. I appreciate today it may not be much of a player, but it may be sophisticated enough to recognize. And you are—well, let me get to this, without bantering too much about this. You are never going to be able to assure us of that, are you? I mean, that is always going to be a risk and possibility if this legislation passes.

Mr. GENSLER. But I could ensure you this. If we don't do this in the United States, others won't do it. We have to show the leadership and, I think, rise to the occasion to bring regulation here. And the President was successful in Pittsburgh to get 20 heads of state to sign on. It was a brief statement, but an important statement about this. I think it is very encouraging.

Senator JOHANNS. That is what we are being told about climate change, too.

The second thing I wanted to ask about—two things relative to the margin requirements. Again, I would love to have an hour with you to delve into that deep, but let me delve into——

Mr. GENSLER. Tell me when you want to schedule it.

Senator JOHANNS. Okay, great. We might do that. We will do that.

Here is what worries me about the margin requirements. Number one, if I take this bank of money to put it into bringing down risk by posting, in effect, a cash bond of sorts, because that is basically how it works, I have taken that money out of the economy and it is now on the sidelines. Now, I have probably brought some risk down. In fact, in the no-risk transaction, we would require 100 percent and then there wouldn't be a risk. But that is not how a free economy works. So that is the number one concern, and I see I have just run out of time, but the second concern is this.

The little guy out there, the small, medium-sized risk hedger, whoever that is, is going to be very limited in how much margin they can put up, how much capital they have access to in reality, and so I just worry that what you are really doing here, if you pound down on these margin requirements, is you have just set a course where bigger gets bigger and we exacerbate the problem of too big to fail. And I will guarantee you, sitting on the Agriculture Committee and the Banking Committee, it is a very bipartisan frustration that we are dealing with, too big to fail.

Mr. GENSLER. I share that frustration and that is what animates me. On the other side, is I think that the large financial houses are

keeping a great deal of risk on their books. The largest financial houses often have between ten and 20 percent of their balance sheet extending credit. Credit is being extended in these derivative contracts. They are central counterparties. They are not well regulated for it. They are also in the underwriting business and proprietary trading business and the leasing businesses and so forth.

So that is why, as a public policy matter, and Congress will weigh trying to move as much of this into central clearinghouses but also weigh the concerns of these end users about posting margin. If they are exempted, I think the next panel, I am hoping you will hear, is fine and, in fact, it is a huge benefit for small and medium-sized companies to see the transactions trade by trade on trading platforms.

Senator JOHANNS. Yes. I will just wrap up with this, before my microphone gets shut off. Transparency is good. I like transparency. I have tried to emphasize transparency is a good thing. How you execute that, again, I think it can send you down a pathway of just encouraging bigger and bigger and bigger to meet the requirements that we impose upon the private sector. Thank you.

Chairman LINCOLN. Senator Thune.

Senator THUNE. Thank you, Madam Chair.

Mr. Chairman, I think the whole focus of this debate has got to be how do we figure out the right way, the balanced way to constrain some of the risk that led to this massive collapse and meltdown that we saw last fall. And I think a lot of this debate, too, comes down to some definitions, who is in, who is out, who is covered, who is not.

And one of the questions I guess I would ask of you, because you stated earlier that the regulator should be the appropriate entity to determine what is a standardized contract, and I guess I would ask you, in light of that, how would you define a standardized contract?

Mr. GENSLER. I think—a very good question. I think there should be a presumption that if it can be cleared, a clearinghouse accepts it, it would be a presumption that it would be clearable. If it had a volume of transactions and had a pricing, clear pricing—one of the things about clearinghouses, they need to know what the pricing is of these transactions.

I remember in February, actually, in front of the committee when then-Chairman Harkin asked me the question, I provided in writing, and I would be glad to get it to you, Senator, five different factors that could be. But it was related to a presumption that if it is accepted for clearing, then it would be standardized, if the clearinghouse took it. If there was such volume in the contract. If it was so similar, there was just one feature that was different, as if somebody was trying to evade the standardization, that would be a factor, for instance.

Senator THUNE. Okay. Do all derivative end users, in your opinion, create systemic risk to the financial markets?

Mr. GENSLER. I think that the greatest systemic risk is housed within the large financial entities. And though individual transactions don't, or even sometimes collection of transactions don't pose that type of risk, that when you go across, if we exempt a whole class of transactions, it is a significant part of the market.

Again, there is not much transparency here. But the end user transactions are significant in dollar amount and even a larger number of the individual transactions, because usually end users have smaller transactions.

Senator THUNE. Right. Do you think that all end users ought to be subject to the same level of Federal oversight?

Mr. GENSLER. I am glad you asked the question. I am not for the end users having oversight. I am for the swap dealers having oversight and that the requirement would be on the swap dealer to bring the transaction into a trading venue, and that would benefit the end user. If Congress were to say that the transaction was brought into the clearinghouse, it would be the responsibility of the swap dealer to bring it in. But the end user wouldn't have oversight, if I can——

Senator THUNE. Okay. If you have a derivative end user like, say, for example, a rural electric cooperative who relies on standard over-the-counter contracts, should they be forced onto exchanges or central clearinghouses if it is a legitimate hedging transaction, something that they are simply doing to manage risk?

Mr. GENSLER. I think they should be able to manage risk however they wish to manage risk. If it is a customized or tailored transaction, then I would say no. But if a trading venue actually listed it for trading, it was so standard, it is a one-year contract for natural gas and it was similar to many of the transactions currently listed on the exempt commercial markets that we know of and talk about, ICE Atlanta, then the swap dealer would be required to bring it and make sure that small rural electric cooperative would be able to see the transactions of similar electric cooperatives in other States. They would never see the name, but they would see the price and volume. I think that would benefit them.

Senator THUNE. Okay. Thank you, Madam Chair. Thank you, Mr. Chairman.

Chairman LINCOLN. I think——

Senator CONRAD. Madam Chair?

Chairman LINCOLN. Sure?

Senator CONRAD. Might I just make a quick observation that in that meeting that I described where we were told government was going to take over AIG because there would be a global financial collapse if it was not done, what became clear is that AIG had written insurance contracts and they didn't have the capital to back up the commitment. And somehow, we have got an absolute obligation to make sure that can't happen again, and I don't know how you do that without some margin requirement. It would be unthinkable that we were to permit that same circumstance to occur again.

Chairman LINCOLN. I think we have got a few questions left, but we would like to do maybe one quick round, because we do have another panel and we do have a nomination hearing, so I am going to defer to my colleague, Senator Chambliss. I know he has got to step out for a few moments.

Senator CHAMBLISS. Thank you, Madam Chairman.

Picking up where Senator Conrad left off there, you talked about some of these institutions being too big to fail and the sophisticated institutions that were dealing in this—that do deal in this market,

and that those are the regular players, so to speak, in the market, versus the small businessman who might kind of almost inadvertently get involved in this.

If we had total transparency, if AIG had been required to report to you or to the CFTC the nature and the details of all of their transactions, would not that have put not only CFTC in a better position, but the potential buyers of AIG products or investors in AIG products in a much better position to look at them and say, wow. They have got all these transactions out there and all these obligations out there, but they don't have the capital. And aren't these sophisticated traders just that? They are so sophisticated that they would have known that AIG was not capable of delivering on the products that they were selling, or that their capital was so low that there was no way they could meet those commitments and they wouldn't have made the investment if there had been total transparency at that time. Is my thinking right there?

Mr. GENSLER. Senator, I think that the markets need more than that. Transparency is critical——

Senator CHAMBLISS. I understand that——

Mr. GENSLER. —but as Senator Conrad said, I think the need to have the authority to effectively say an AIG or the next AIG has to have capital, has to have cushions really built in, and even business conduct standards and so forth, are critical, as well.

Senator CHAMBLISS. I understand that, and that is why we have got to look at the other portion of that. But from a transparency standpoint, isn't that correct, that investors would have been so sophisticated that they would not have made additional investments in AIG?

Mr. GENSLER. Though I would like to agree with you, as I would like to agree with every Senator, I think that the crisis showed that many sophisticated actors made whopping big mistakes. And AIG—I think we can't just rely on sophisticated actors making the choices. I think we need to regulate the big swap houses and make sure they have the capital and the business conduct standards right there.

Senator CHAMBLISS. I guess my point is, I don't disagree with what you are saying, but I agree that there has got to be transparency, and I think we have all said that today. There will be some additional issues relative to the margin requirements, position limits, whatever, but my point is that if we don't put in legislative language a requirement that there be total transparency and that transparency would lead an investor to shy away from somebody who is undercapitalized, then I think we have failed. So I want to make sure that we are talking along the lines of putting in legislative language the capability of an investor to be assured that the seller of a product does have the capital to back up that product.

Mr. GENSLER. I think such transparency would be a positive and a net benefit to the markets and I think it sounds like we are in agreement, but we need other factors, as well, in this——

Senator CHAMBLISS. I don't disagree with that, but yes. Okay. Thank you.

Chairman LINCOLN. Just quickly, in the last farm bill, we passed some reforms that granted CFTC the authority to regulate con-

tracts with a significant price discovery function. I would just like to hear from you how those reforms are working. Specifically, how many of the SPDC reviews have you undertaken since you have been given the authority to do so and how do you plan to use this authority in the future?

Mr. GENSLER. I thank you. The authority really was looking at trading venues called exempt commercial markets and trying to bring greater regulation to those where the contracts were similar or look-alike, as the documents had significant price discovery. We went through rule writing in the spring, and then subsequent to the rule writing have put out the determination, I think it is 43 individual contracts. Because——

Chairman LINCOLN. That is more than predicted, I believe.

Mr. GENSLER. More than was predicted, that is correct. But subject to the rules, there are four factors to be considered. We have put them out. One has actually been determined to be—because it was the first one we put out, the other 42 are still getting public comment and so forth— one has been determined. It is the natural gas contract on ICE, and then ICE Atlanta then had to put in place the self- regulatory functions that this committee and Congress required of them, and we are getting now the reporting and so forth. And we are going to sort through—we are in a determination phase now, but we are going to sort through the other contracts. Most of them are in the—in fact, I think all of them are in the energy space.

Chairman LINCOLN. Thank you.

Senator Conrad?

Senator CONRAD. Thank you, Madam Chairman.

I want to go back to this question that was kind of ping-ponging back and forth with Senator Chambliss, because I think it is very important we get this right. A couple of years ago, I was at a charity dinner and had seated next to me a man who was in charge of all derivatives trading worldwide for a major financial institution that no longer exists. They were brought down by this derivatives disaster. And during the course of this dinner, we talked about derivatives.

I raised with him—because just a few weeks before, I had asked my staff to bring me a formula that is used to measure the risks of a derivative deal. I wanted to see if I could understand it, because I have a Master's in business and I would have had that training about the time most of the people running these companies would have had their training. So I just wanted to see, would I be able to understand it. They brought me a formula. I couldn't make heads nor tails out of it.

I said to this man, again, who was in charge of all derivatives trading for this major firm worldwide, I said, how many of the top executives of your firm do you think understand these formulas that determine, supposedly measure the risk of a deal? He said, "I don't think any of them understand it." He said, "I don't understand it."

And I tell you, I remember my feeling when he told me that. My God, this is the guy that is in charge of derivatives trading worldwide for a major company and he doesn't understand the formulas. And I understood, because, you know, I am pretty good in math.

I couldn't understand it. And I will bet you a lot of money these guys would go to board meetings. Nobody wanted to be embarrassed and ask the question, what does this really mean?

And in AIG's case, the vast majority of that company was sound. They were doing strong business worldwide. What brought them down was a 500-member outfit that engaged in these derivative deals, and they never—they couldn't conceivably back up the insurance products that they were selling. And they almost brought this whole thing to its needs.

So for this member, transparency, absolutely. And to the point Senator Chambliss was raising, I do think it would make a difference if people were able to see, because, I mean, this gentlemen told me nobody knew how many derivatives deals were out there because there was no place it was reported. That has got to be.

But then we have got to go another step. We have got to make certain that folks have the capital to back up the promises that we are making. Is that your position?

Mr. GENSLER. It is, Senator. I think that one of the critical functions of the regulatory group—and financial regulation failed the American public. I mean, there is no doubt about that. But the financial system also failed, and it wasn't just AIG. It is to make sure that these financial institutions, and they are more highly concentrated today than they were ten years ago—it is not uncommon, it happened in the airline industry, it happened in the drug industry—but in this industry, it is so consequential because they are intertwined in the fabric of every company, all the end users you will hear from and so forth, that they have enough capital, that their business conduct is such that it lowers risk, not heightens risk, and in my recommendation that we move what we can off the books into these central clearinghouses.

They operate as a fiduciary duty, with a profit motive, as they should. They are for-profit companies. That means they want to make as much profit on as little capital and survive. They don't want to go under. But that is different than the responsibility to the taxpayers that I feel in my job every day, is to make sure that there is enough capital that this crisis can't happen again.

Chairman LINCOLN. Senator Lugar, anything else? Senator Cochran, Senator Johanns?

Senator JOHANNS. I hope you don't take my asking hard questions as feeling one way or the other about this. I just think we have to ask hard questions. I once had a law school professor tell me—and anybody who has gone through law school has probably heard this—hard cases make bad law, this law professor said, and it is true. The most difficult AIG kind of cases can sometimes lead to terrible results if we are not paying attention.

So let me just ask you on this margin phenomena, could AIG borrow money to make the margin call? I mean, they have access to great—or did have access to great capital at one time. Could a company go out under the administration proposal and meet the margin requirements by borrowing money?

Mr. GENSLER. They could. They could. But importantly, the large financial houses, like an AIG in the future, would be less interconnected because these transactions would have to be moved off of their books into these clearinghouses. What happened in AIG,

they had about a $450 billion credit default swap book and their counterparties were not asking for margin to be posted. They said, well, they are fine, you know. And one day in September of last year, they were downgraded by the rating agencies and all of a sudden they had to post $30 billion, and you know the rest of the story. The taxpayers put it up.

Senator JOHANNS. It is just, you look at AIG and you wonder how people got paid so much to make such poor decisions, to be very blunt about it. And it is not just AIG. There were a lot of very, very bad things going on.

To follow up on this question of capital to cover risk exposure, I mean, all of our economy is working with risk exposures. I buy a million-dollar life insurance policy, hypothetically. They are banking that they get to use my premiums long enough before they have to pay out on that. And in the world, some risk is—a situation in life insurance, well, some die sooner than expected, others don't, and on and on. But if you had a phenomena, say, in the casualty industry where you had a massive hurricane event, for example, yes, the claim problems can be absolutely overwhelming. They do not have oftentimes enough money sitting there to cover all of the claims, right? And isn't that the balance we are trying to strike here?

Mr. GENSLER. It certainly is, but I think this was more than just, if I can say it, an analogy of the 50-year flood or the 100-year flood. I think that the financial system had—and the regulatory system had real gaps and this over-the-counter derivatives marketplace is a real gap.

We do have regulated securities markets. We have regulated futures markets.

Senator JOHANNS. Sure.

Mr. GENSLER. This market is larger than the futures markets by orders of magnitude. I think we need to bring similar discipline to it.

Senator JOHANNS. And again, I am going to work with you to try to get there. I just want to make sure that in this hard case, we don't make bad law. That is why I ask these questions. I think it is just important that we try to get a sense of what we are doing here, so thank you, Mr. Chairman.

Mr. GENSLER. I appreciate the hard ones and even the easy ones.

Senator JOHANNS. Great. Thanks.

Chairman LINCOLN. Senator Grassley, we are finishing up the second round. If you have got anything for the Chairman, we would ask it now and we will then move to our second round.

Senator GRASSLEY. Thank you. We have questions from end user witnesses after you and they are going to testify that exemptions for bona fide hedgers and legitimate end users should be granted from regulated exchange requirements because it will, in short, break the bank. CAn you elaborate on what specific threats these users pose to financial stability?

Mr. GENSLER. Good to see you again, Senator. I believe that it is the large financial institutions that pose the greatest risk. But at the end of every financial institution, there are thousands of end users. So it is not any individual end user, but what we are really

trying to do is lower the risk to the American public and promote transparency.

Exchanges that you mentioned are actually a benefit to end users, and I think most end users would like to have transparency. What they are worried about is posting margin on something called a clearinghouse. A clearinghouse happens after the transaction, and while it is related to an exchange, I think that is what they are most worried about, is the cost of possibly posting margin. But the real risk is the large financial institutions being so interconnected.

Senator GRASSLEY. Your testimony includes support for a trade repository that would assist regulators. Could you expand on who and how this repository would be administered and how will this be kept independent from market players?

Mr. GENSLER. I think it is important that trade repositories and clearinghouses, which will serve in some way the public, broad public, be robustly regulated by the market regulators for governance, that the governance is an open governance and not sort of controlled by sort of a club deal amongst dealers. And the trade repositories are a place where all the regulators should be able to see the transactions. That is a regulatory transparency. And that our trade repositories and the European trade repositories, I believe, should be open and available that we can see as regulators that information.

Senator GRASSLEY. Okay. Probably all the witnesses at the hearing will agree with you that greater transparency and more information for both market participants and consumers will be beneficial. One recommendation is to aggregate data on the OTC trades and make them available to the public. Could you explain how you would make this available to the public but at the same time safeguard information that could be used to manipulate the markets?

Mr. GENSLER. As we do it, the CFTC, we put out a weekly report right now on the futures market and we aggregate data around large traders and we put that out every Friday. I think, similarly, we should promote aggregate data of customized and standardized product out to the marketplace. I do think market participants also benefit if individual trades are transparent, if they are standard enough to be listed on execution facilities. And that is really one of the best ways to protect against manipulation.

But I also hope to work with this committee and you, Senator. I think we need to enhance the CFTC's authority to police the markets against manipulation and we do have some statutory language to address specific disruptive practices.

Senator GRASSLEY. Thank you, Madam Chairman.

Chairman LINCOLN. Thank you, Senator Grassley.

Chairman Gensler, thank you again. You have been most gracious with your time. We appreciate that. We look forward to continuing to work with you as we move forward to find the kind of solutions that will really put our economy back on track and provide that kind of confidence in the consumer and the marketplace that we all know that we need, and more importantly, that we can provide, so——

Mr. GENSLER. Madam Chairman, members of the committee, I thank you and I look forward to working with all of you and making our staff and me available to any questions you have.

Chairman LINCOLN. Great. Thank you for joining us today.

We would like to now call the second panel, if we could. First of all, we have got Glenn English, who became the fourth executive officer of the National Rural Electric Cooperative, chief spokesman for the nation's consumer-owned cooperative electric utilities. He represents the national interest of electric cooperatives and their consumers before

the United States Congress and executive branch, the Federal agencies.

We are also being joined by Mr. Neil Schloss, Treasurer for Ford Motor Company, a position to which he was elected in March of 2007. He joined the Ford Motor Company in 1982 as a financial analyst in the comptroller's office. From there, he has progressed through a series of finance positions at Ford Aerospace before transferring to Ford in 1990.

We would also like to welcome Mark Boling, who is an Executive Vice President and General Counsel of Southwestern Energy Company. Prior to joining Southwestern in January of 2002, he was in private practice in Houston, specializing in oil and gas transactional work.

We are also being joined by Jeff Billings of the Municipal Gas Authority of Georgia, Manager of Risk Management. Jeff is responsible for the development and the execution of hedging strategies for the Gas Authority's hedging program. He also works closely with the members and partners of the Gas Authority to develop and implement hedging plans.

And we are also joined by Dr. Robert Johnson. Dr. Johnson is an international investor and consultant to investment funds on issues of portfolio strategy. He currently serves on the United Nations Commission of Experts on International Monetary Reform under the Chairmanship of Joseph Stiglitz. Dr. Johnson is also the Director of Economic Policy for the Franklin-Eleanor Roosevelt Institute in New York, and we are pleased to be joined by him as well.

Thank you, gentlemen, for coming to work with the committee on such a critical issue and we look forward to your testimony and then are, again, grateful for your being able to stay and answer our questions, as well.

Congressman English.

STATEMENT OF GLENN ENGLISH, CHIEF EXECUTIVE OFFICER, NATIONAL RURAL ELECTRIC COOPERATIVES ASSOCIATION, ARLINGTON, VIRGINIA

Mr. ENGLISH. Thank you very much, Madam Chairman. I, too, want to join others in congratulating you on your new position. We certainly are enthusiastic about the kind of leadership that we know that you will provide to this committee and to rural America in general, so congratulations once again.

Chairman LINCOLN. Thank you very much.

Mr. ENGLISH. Thank you. I think most of the members of this committee, certainly those that are present, are very familiar with electric cooperatives. I don't need to really go into the background

about there being not-for- profit, consumer-owned, 930 cooperatives in 47 States all across this country.

But certainly we have a great interest in the subject at hand. We want to commend the committee and certainly encourage transparency, encourage any action that you can take that will deal with any market manipulation that may be taking place and any abuses that we may have seen in the past.

I recall some 20 years ago—goodness, it doesn't seem that long, but 20 years ago when I served as Chairman of the subcommittee in the other body dealing with this very same issue, wrestling with some of the very same questions that I heard asked this morning. So this is one that has been with us and I commend you for continuing to work to get it right and to get it focused.

I certainly appreciate and understand also that much of the discussion this morning is with regard to some of the larger participants in the derivatives market and the impact that they have had recently on our economy and some of the shortcomings that we have seen in that marketplace.

I am here to represent some of the smallest of the participants in this particular market, but we have just as great an interest in a functioning market and legislation could have just as great an impact with regard to electric bills for those 21 million people who are represented on the Agriculture Committee through the cooperatives that you have in your particular States. And in this particular case, we find that we are concerned about one thing, and that is affordability.

It is important for us to be able to hedge. It is important for us to be able to reduce risk. And certainly that has helped in keeping electric bills reasonable and affordable for our membership, and we need to continue to do that in the future. I think that a lot of the members of the committee fully understand how volatile fuels can be and the impact that can have on the electric bills of your constituents. Certainly, anything that we can do to bring stability in that area is certainly beneficial. So we want everyone to understand where we are coming from there.

Interest rates swaps are also very important to us and can have a very big impact. As you know, we don't have a lot of cash on hand. Much of our cash has to go into that infrastructure. The 42 percent of the distribution lines of this country that are owned by electric cooperatives must be maintained by electric cooperatives. So we have a huge amount of infrastructure that has to be dealt with and a lot of the resources that we have go into that particular region.

Not having money on hand puts us in the difficult position that the more volatility that is brought into constructing our plants and financing our infrastructure obviously means we have to go into the marketplace and borrow more money, and in some cases we have to borrow a lot of money. If we have one other element added, namely the volatility of fuels if we can't hedge without clearing, if we can't deal with swings in the marketplace, because it means we have to borrow a great amount of money for margin that is going to impact those electric bills each and every month.

As the Chairman just recently discussed in response to a question from this committee, there is no question that the margin call

issue is a big issue for us. It is a big concern for us. If, in fact, we are suddenly hit with the need for a margin call to go out and borrow a lot of money to be able to meet that margin call, that can have a huge impact as far as the electric bills of some local electric cooperatives. So where we are coming from and what we are focused on is dealing with this particular issue.

Of the legislative proposals that we have seen put forth, both from Treasury and from others here within the Congress, we have been working with the various committees and trying to find out if there isn't some way that the smallest of those who use these markets, not for speculative purposes but for purposes of legitimate hedging, if there isn't some way in which we can assist the committee in this issue of providing a great deal more transparency while dealing with manipulation, but at the same time not impacting those electric bills of the folks back home, in trying to keep this thing at a manageable degree.

Now, attempts have been made. Certainly, the Treasury Department has made that attempt, and one of the proposals here in Congress is to use GAAP. The difficulty that we have with using GAAP is that while it does through its exclusion provide a way in which you can deal with the margin issue, the question is whether we can qualify on any particular trade for GAAP. So it brings more uncertainty in, and uncertainty itself provides us with difficulty.

So as the committee wrestles with this issue, as you look at how we can provide more transparency, if you look at how we might deal with any manipulation that might be taking place, I would simply urge the committee to do everything that they can to also keep affordability for some of the small users that are using it for legitimate hedging purposes in mind, as well.

I thank the committee and I appreciate it very much.

[The prepared statement of Mr. English can be found on page 75 in the appendix.]

Senator CONRAD. [Presiding.] Thank you, Mr. English.

We will go next to Mr. Schloss, the Treasurer of Ford Motor. Welcome.

STATEMENT OF NEIL M. SCHLOSS, VICE PRESIDENT AND TREASURER, FORD MOTOR COMPANY, DEARBORN, MICHIGAN

Mr. SCHLOSS. Thanks very much, and good morning.

Senator CONRAD. Please proceed.

Mr. SCHLOSS. Madam Chairman, Ranking Member Chambliss, and members of the committee, my name is Neil Schloss and I am the Treasurer of Ford Motor Company. I want to thank the committee for inviting me to testify and share the views of Ford Motor Company on a very important issue regarding financial derivatives and their regulation. The views that I express today are those of Ford Motor Company and their subsidiaries.

Derivatives are an integral part of Ford's business of manufacturing, sale, and financing of vehicles worldwide. Ford employs derivatives to manage business risk so we can achieve stable cash flow and profitability in an increasing volatile global economy. We do not use derivatives to speculate or bet on potential changes in the economy or the financial markets. Our use of derivatives are

focused on mitigating risks arising from our normal business operations.

We fully support the legislation to increase transparency and oversight of the over-the-counter markets and participant activities. As an end user of derivatives, Ford would benefit from strengthening the derivative market and bank counterparties. We agree with general intent of most of the draft legislation that focuses on swap dealers and major swap participants and to exclude end users such as Ford and its affiliates from clearing, margin, and capital requirements.

Like other end user manufacturers with captive finance companies, we are concerned that margin requirements would significantly increase our costs and liquidity requirements and could provide a disincentive to hedging our business risks. Most corporations do not have immediate and low-cost access to liquidity, such as the Federal Reserve discount window or FDIC-insured deposits. An end user raising capital requires lead time and is often very expensive.

Ford's use of derivatives shows why the regulations are critically important to all end users. As of September 30, the net fair value of our derivatives was about $800 million, and this is the amount that the bank counterparties would have to pay us to terminate existing transactions. Our total derivative notional outstanding is about $108 billion, which includes $93 billion of hedging interest rates, $14 billion hedging foreign exchange, and about a billion hedging commodity price risks. The automotive derivative book is just over $7 billion, and that is small compared to historical levels, and especially small compared to our financial services book, which is about $101 billion. But as the markets change and as our business grows, that could change significantly.

Although we see the merits of credit default swaps, or CDS, in facilitating risk management and access to capital, we do not buy or sell CDS derivatives ourselves.

In the automotive business, Ford uses derivatives to hedge currencies and commodities in order to lock in near- term certainty for our revenue and costs for global vehicle production. We are a capital-intensive business with various manufacturing facilities producing and selling cars around the world. For example, we use over-the-counter derivatives to hedge currency exposure resulting from our F- series production here in America in U.S. dollars and some of the sales being sold in Canada and Mexico in Canadian dollars and pesos. Similar exposures and trade flows exist all over Ford's worldwide operations on finished products, components, and raw material.

We also use over-the-counter derivatives to hedge commodities, such as aluminum and copper, and we opt to long-term supply agreements to hedge those commodities that do not have a deep or liquid derivative market.

Many of the product and sourcing decisions are made years in advance of when the product actually reaches the customer. Without hedging, we would be exposing ourselves and our customers to high volatility and price risk.

One of the biggest concerns relating to the derivative market reform is the potential disruption that would have on a pretty fragile asset-backed securitization market. Mandatory clearing and mar-

gin requirements for securitization derivatives, which as you all know makes up a significant part of Ford Credit's funding today, would cause major structural changes on our existing transactions and future transactions in what is still a fragile market, despite TALF's success.

During the credit crisis, many financial institutions curtailed credit capacity, but Ford consistently supported most of its 3,000-plus dealers and Ford Credit's portfolio of more than three million active retail accounts. It is vital in that recovery that the securitization market continue so we can continue to support our dealers and our customers.

In our view, securitization trusts should qualify for end user exemption, as well, because securitization derivatives are uniquely structured and only protect the investor. In absence of end user exemption, we would strongly advocate that securitization derivatives be allowed an exemption similar to that which is being widely distributed for foreign exchange swaps and forwards in various Senate and House proposals.

So in summary, we appreciate that Congress recognizes that end users such as Ford use derivatives to mitigate risk. As legislation is crafted, the distinction between pure risk mitigation and speculation is important to maintain. End users represent only a small fraction of the estimated $600 trillion outstanding in the over-the-counter market. All our derivatives are used to risk mitigate, and credit risk that is entailed within them are priced and fully paid up front when the transaction begins.

We thank this committee for giving derivative market reform the serious attention it deserves and inviting us to share our views with you, and at the end of the panel, I welcome your questions. Thank you.

[The prepared statement of Mr. Schloss can be found on page 122 in the appendix.]

Senator CONRAD. Thank you, Mr. Schloss.

Mr. Boling.

STATEMENT OF MARK BOLING, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, SOUTHWESTERN ENERGY COMPANY, HOUSTON, TEXAS

Mr. BOLING. Thank you. My name is Mark Boling and I am Executive Vice President and General Counsel of Southwestern Energy Company, an independent energy company primarily engaged in natural gas exploration and production within the United States. I appreciate the opportunity to appear before you today and provide testimony regarding the very important legislative effort to reform the over-the- counter derivatives market.

One of the biggest challenges in enacting legislative reforms for the over-the-counter derivatives market is that the term "over-the-counter market" covers a vast array of products across a number of markets, thereby making it extremely difficult to implement an effective one-size-fits- all solution. In this regard, it is important to note that energy derivatives did not cause the financial crisis of 2008. Credit default swaps and subprime mortgages did. It is also important to note that while we have witnessed the greatest economic crisis in 80 years and perhaps the most volatile commodity

markets Southwestern ever experienced, over-the-counter derivatives in the energy markets performed well, did not create systemic risks, and, in fact, helped many end users manage and hedge their risks during this very difficult time of extreme volatility.

We support all legislative efforts to improve the transparency and stability of the over-the-counter derivatives markets and to ensure market integrity by preventing excessive speculation, manipulation, and other abusive practices. However, we believe that any such legislation must recognize the significant differences between the various derivative markets and make a clear distinction between those market participants that engage in hedging transactions with a goal of managing the price risk inherent in their business and those market participants that engage in speculative transactions with the goal of achieving profits through the successful anticipation of price movements.

My testimony today will focus on four things: Why over-the-counter swaps are so important to independent energy companies like Southwestern; the impact on Southwestern and other independent energy producers if they are required to clear or post cash margin for their hedging transactions; Southwestern's recommendation for the treatment of hedging transactions; and Southwestern's support of market transparency and reporting.

Southwestern Energy Company is a growing independent energy company. Since 2005, Southwestern invested over $6.5 billion in its operations, all of which are located in the United States. These investments have resulted in substantial domestic job creation, increased direct and indirect business expansion, and significant Federal, State, and local tax revenues. Within our company alone, we have increased our employee base from 248 employees at year-end 2004 to approximately 1,500 employees today, an increase of over 600 percent.

Our ability to make over $6.5 billion of capital investments and create thousands of job opportunities during this period was primarily due to our ability to generate a reliable cash flow from the sale of our natural gas production and to gain access to additional funds borrowed under our bank revolving credit facility. The ability to generate our reliable cash flow was due in large part to our use of over-the-counter derivatives to lock in natural gas prices. Southwestern uses these derivatives as a risk management tool for our natural gas, a commodity that we produce, own, possess, and market. We do not use derivatives for speculative purposes.

Southwestern regularly hedges its natural gas price exposure by entering into over-the-counter swap transactions with multiple counterparties with S&P credit ratings ranging from triple-B-plus to double-A. Southwestern has typically hedged 60 to 80 percent of its expected natural gas production volumes for the following year. Southwestern does not post collateral with any swap counterparty for a very good reason. Natural gas swaps lower Southwestern's business risk and makes it a much more stable company. Like all commodity producers, Southwestern is naturally long in commodity, and hence naturally subjected to the risk of falling commodity prices. Southwestern's swap counterparties understand that Southwestern is reducing its business risk when transacting over-the-counter swaps, and therefore the credit risk to the swap dealer

is greatly diminished, thereby eliminating the need for Southwestern to post collateral.

Increasing hedging costs by forcing all standardized derivative trades onto a clearinghouse will result in fewer market participants, more price volatility, and less price discovery. Because of the increased cost, fewer market participants will be able to hedge, or the ones that can hedge will hedge a lower volume. With fewer transactions and fewer participants in the marketplace, there will be more price volatility and less price discovery. By driving out the bona fide hedgers, the market share of speculators will increase, which does not create a healthy functioning environment. A healthy market requires a balance between bona fide hedgers and speculators.

Finally, if the independent energy producers are forced to post cash collateral for natural gas hedging activities, they will be unable to fully invest in their business, the exploration and production of natural gas. The additional cost from posting cash collateral will be substantial and necessarily require that independent energy producers reduce their capital investments, resulting in a dramatic reduction in drilling activity, fewer jobs, and a significant decrease in domestic natural gas production.

After analyzing the potential costs of posting cash collateral, Southwestern determined that during 2009, without hedging, Southwestern would have drilled 240 fewer wells in its Fayetteville Shale Project, resulting in the loss of 1,500 jobs and a total economic impact to the State of Arkansas of $1.6 billion. In addition, fewer wells drilled in the United States means less domestic gas is produced, and less gas produced unfortunately means higher prices for consumers. There is a real world effect to a mandatory clearing requirement for all standardized over- the-counter derivatives.

Southwestern believes the solution to these problems would be to provide an exemption from the clearing and margining requirements for bona fide hedging transactions where at least one party involved is a company that produces, owns, and sells the commodity and the transaction is directly related to managing commodity pricing risk inherent to that company's operating activities.

In conclusion, a clearing requirement for over-the- counter derivatives, when applied appropriately, can play an important role in mitigating operational and counterparty risk for large segments of the over-the-counter derivatives market. However, we believe the broad application of a clearing requirement for all over-the-counter derivatives will hurt many American companies, particularly in the energy sector, by effectively taking away the most powerful tool for managing price-related risk.

It is our hope that the concerns we have raised are addressed so that any proposed legislation does not significantly impair our ability to use derivatives to prudently hedge the risks we face in our day-to-day operations or to ensure our continued access to the credit sources we rely upon to grow our business. Ultimately, what matters most is that American companies continue to be allowed to cost effectively manage risk in a manner that enhances market stability and contributes to both the overall health of the economy and our country's goal of achieving energy independence.

Madam Chair and members of the committee, this concludes my testimony. I would be happy to answer any questions.

[The prepared statement of Mr. Boling can be found on page 65 in the appendix.]

Chairman LINCOLN. [Presiding.] Thank you.

Mr. Billings.

STATEMENT OF JEFF BILLINGS, MANAGER OF RISK MANAGEMENT, MUNICIPAL GAS AUTHORITY OF GEORGIA, ON BEHALF OF THE AMERICAN PUBLIC GAS ASSOCIATION, KENNESAW, GEORGIA

Mr. BILLINGS. Thank you. Madam Chairman Lincoln, Ranking Member Chambliss, members of the committee, I appreciate this opportunity to testify before you today. My name is Jeff Billings and I am the Risk Manager for the Gas Authority of Georgia. The Municipal Gas Authority of Georgia is the largest nonprofit natural gas joint action agency in the United States. We have 76 public gas system members in five States, including Georgia, Florida, Alabama, Pennsylvania, and Tennessee. Together, these systems meet the gas needs of approximately 243,000 customers.

I testify today on behalf of the American Public Gas Association. APGA is the national association for publicly- owned not-for-profit natural gas retail distribution systems. There are approximately 1,000 public gas systems in 36 States.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. If we are to fully utilize natural gas at long-term affordable prices, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation or other market abuses.

Public gas systems depend upon both the physical commodity markets as well as the over-the-counter derivatives markets to meet the natural gas needs of our consumers. Both markets play a critical role in public utilities securities natural gas supplies at stable prices.

Since 2005, APGA has been a strong supporter of increasing market transparency, limiting excessive speculating, and providing the CFTC with the resources it needs to protect consumers. APGA believes that provisions relating to the unregulated energy trading platforms contained in the CFTC Reauthorization Act passed last Congress was and is a critically important step in addressing our concerns.

We commend this committee for its work on the Reauthorization Act. However, APGA believes that significant regulatory gaps still exist with respect to the over-the-counter markets. Congress should provide the CFTC with additional statutory authorities to enhance transparency, limit excessively large speculative positions, and help prevent market abuses.

As this committee considers reforms to OTC markets, we are extremely concerned about the cost impacts of proposals that would require all standardized OTC transactions to be cleared. Mandatory clearing would significantly impair the ability of public gas

systems to engage in the gas supply strategies that we have historically utilized.

Under current practices in the OTC markets, many public gas systems, based upon their very high creditworthiness, are not required to post collateral as long as their exposure stays below a predetermined threshold. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and to meet maintenance margin calls whenever required and on little notice. This would constitute a significant financial and operational burden on public systems that would be borne 100 percent by consumers.

In the case of the Municipal Gas Authority of Georgia, mandated clearing would require, based upon our current hedge positions, the posting of initial margin in the range of $163 to $243 million. In addition to the initial capital requirements, we would also be responsible for additional capital contributions based on mark-to-market calculations.

It has been suggested that the clearing requirements would be less burdensome if some end users are given the option of posting non-cash collateral. Unfortunately, the alternative of using non-cash collateral would not provide any relief to public gas systems. Non-cash collateral would entail the deposit of liquid assets and public gas systems simply do not maintain liquid assets in the quantity necessary to meet the requirements associated with clearing.

APGA understands that proposals to require clearing of all OTC transactions are intended to address issues related to systemic risk and prevent future bailouts. However, the hedging of natural gas supply purchases by public gas systems using non-cleared bilateral OTC derivatives do not prevent systemic risks to the market.

In addition, the proposed mandate to clear all standardized OTC derivative transactions would increase costs for public gas systems and their municipalities, an increase which, again, would be borne 100 percent by consumers. This increase in consumer cost comes without any benefits. In essence, we feel it would be punishing the victims.

We look forward to working with the committee towards the passage of legislation that strikes an appropriate balance that allows end users, such as public gas systems, to continue to use the over-the-counter markets without incurring additional costs to hedge risk while enacting reforms that would protect our financial system. Thank you.

[The prepared statement of Mr. Billings can be found on page 54 in the appendix.]

Chairman LINCOLN. Thank you.

Dr. Johnson.

STATEMENT OF ROBERT A. JOHNSON, DIRECTOR OF ECONOMIC POLICY, THE ROOSEVELT INSTITUTE, ON BEHALF OF AMERICANS FOR FINANCIAL REFORM, NEW YORK, NEW YORK

Mr. JOHNSON. Madam Chairman, Ranking Member Chambliss, and members of the committee, I want to thank you for inviting me to testify before you here today. I represent on this day Americans

for Financial Reform, who are a collection of 200 organizations who are taxpayers, workers, and the end users' end user.

The American people clearly sense that there is something deeply flawed in the current structure of our financial markets. The financial sector calamity spilled over and did great harm to the lives of many Americans and people throughout the world. When they are properly designed, financial markets play a fundamental role in the resource allocation of our society. Financial markets serve to aggregate savings and allocate them to productive use and to transfer risk to entities that bear it most comfortably. The system we have had in place in recent years and the one that is still in place as we meet today has revealed itself to be profoundly flawed.

Efforts to repair these market structures in light of the crisis should address and seek to rectify four core problems: Excessive leverage, opacity and complexity, the ability to buy insurance without an insurable risk, and the misalignment of incentives, where the private incentive to take risk exceeds the social desire to bear that risk.

Certain types of derivative structures have contributed to all of these problems and it is time for a thorough redesign of the market system to fortify the real potential derivative instruments and repair the obvious flaws in structure that have caused so much harm.

I must admit that I am very surprised by the intense focus on end users of derivative instruments. They are at present, by their own claim, a relatively small part of the market, and that focus does appear to me to have substantially misdirected energy away from the essential task of financial reform that is before the United States Congress and that centers on the regulation of large-scale financial institutions who threaten our economic system.

This diversion of focus on end users is not independent of that quest and it is a dangerous exercise for at least two reasons. First, efforts to legislate what type of institutions are exempt from restrictions of healthy market practice runs the risk of creating loopholes that could be large enough to drive a jet aircraft through. End users' exemptions are drawn too broadly and they would allow anyone and everyone to claim them, especially the large "too big to fail" institutions that stand next to the public treasury and are the dominant actors in the opaque OTC market. That would directly undermine the need to bring these markets out of the dark. It would enable the largest market participants to remain in the shadow, where they earn profits—extraordinary profits—but put society and the public treasury in peril.

In addition, end user exemptions may inadvertently spawn large organizations or divisions of the organizations the incentive to create Enron-like entities as the risk implicit in creating legislation that confers special advantage for special types of market participants.

A second danger is the exemption of certain classes of financial products, such as foreign exchange forwards and swaps or any products that are traded on foreign platforms and serve to drive more activity offshore, perhaps to locations where the underpinning market structures are themselves quite unsound. Foreign exemptions will also divert creative energy into the creation of complex foreign exchange-based products to qualify for the exemptions and

avoid the scrutiny and structures that they require for systemic safety.

There has been a great deal of recent testimony, and it goes into some length to justify end user exemptions. This body of testimony tries to illuminate the consequences for end users, require them to trade upon exchanges or submit their transactions to clearinghouses. While I do agree that some increase in cost will be borne by these end users if the current structures are replaced by more robust and healthy market structures, I believe the magnitudes of the costs they report that they would incur pale in comparison to the cost this crisis inflicted on society.

I do agree that the end users were not the primary cause of the recent crisis and they are not deserving of any particular punishment. Yet punishment is different than the adjustment to the removal of unhealthy subsidies. I don't believe their arguments should dissuade you from undertaking profound institutional reform, even reform that impacts their practices.

Economists are fond of saying there is no such thing as a free lunch, and efforts to hedge market exposures by commercial users are primarily a transfer of risk rather than a diminution of underlying risk. An oil hedger is not reducing the volatility of oil prices, but merely transferring the risk to another party who will bear that risk for a price.

When market structures are weak and unsound, they underprice that insurance and encourage the over-use of insurance. In the case of OTC derivatives that are largely run by the handful of "too big to fail" banks, the insurance offered to end users is often underpriced because the risk is borne in part by the public or the taxpayer who underpin the safety net that backstops these banks.

Removing the back room subsidy and excessive use it inspires, something oftentimes referred to as moral hazard, would lead to an increase of cost to providing that risk insurance. Removing the subsidy would diminish profits for end users. That leads to less use of insurance and some greater cost for the consumers of those end users' services.

Where I differ with many of the end users is the claim, I believe this would be a good thing—is that I claim this would be a good thing for the nation as a whole. Removing subsidies to the buyers of insurance does not make the world a more dangerous place. It merely redistributes who bears that risk away from those who had provided the subsidy.

The American private sector, be it end users of financial products or financial institutions, do not need to clamor for subsidies from the taxpayer in order to thrive. That type of rent-seeking behavior is demoralizing for society and it is unproductive. It weakens the economy in the long term, and furthermore, government willingness to abide efforts to exact subsidy actually weaken the companies who receive them. The dependence on government subsidy allows the private sector's creative powers to atrophy. We would all do much better in the long term if we were shown tough love, were refused state welfare and forced to focus on new product development and innovations in the marketplace that would create a strong, profitable, productive future in the business sector and for the nation.

Reforming the financial structure of the U.S. marketplace is essential to restore confidence in the United States. Transparent market structures, proper capitalization, regulation, restoration of market discipline to our largest financial institutions are the essential ingredients that are needed to restore that confidence.

Finally, if this is done properly, it will also greatly diminish the possibility that future financial bailouts will reemerge and crowd out the use of our public finances for much-needed infrastructure, education spending, health care, and other things that make our society stronger and our lives more secure.

I will submit the balance of my remarks for the record. I thank you, and I look forward to your questions.

[The prepared statement of Mr. Johnson can be found on page 90 in the appendix.]

Chairman LINCOLN. Thank you, Dr. Johnson, and thanks to all of you all for joining us today.

We have heard some testimony today that our financial system has been put at risk by certain actors who have been over-leveraged and undercapitalized. It is important we find a balance to protect markets and consumers, and to that end, I just have a couple of questions for all of you and then a couple of specific ones for you, Dr. Johnson.

It has been argued that with wider bid-ask spreads, capital charges, and other fees, that using OTC derivatives to hedge might be more convenient, but it is not necessarily less expensive than exchange trading, even without factoring in the possibility of mandated margin costs. To that end, would you compare the costs maybe, and you don't have to do this today if you don't have it at your fingertips, you could certainly submit it for us, which I think would be very helpful, but to compare the costs for me of one of your most standard contracts conducted over-the-counter versus similar costs of an exchange-traded hedge. As I said, if you don't have that breakdown now, it is certainly something you can get to us in detailed data later, which I think just would be very helpful to members of the committee, to really see what that comparison might be.

And then the other question is to discuss the parameters of a possible end user exemption that you or your group members might support. Do you believe that the financial end users or their affiliates should be permitted to use such an exemption, or should we work to exempt smaller end users and if so, where would you draw the line between the less and more significant players? Or maybe would you suggest some other type of a test in terms of what we could put in there.

So those are the questions I would like to throw out for you all and would like you to answer.

Dr. Johnson, you have heard these end users' arguments today, and obviously you have heard them before, but they are very concerned about the additional margin requirements of mandatory clearing and that those requirements will make hedging with futures contracts prohibitively expensive. What do you make of their arguments, and if there were to be an exemption for end users, what should it look like, in your opinion, or are you adamantly opposed to any exemption?

Also, what are your thoughts on a new resolution regime? I think it is very important for us to eliminate the prospect of "too big to fail" and I understand that we need a resolution regime in place that would account for how we very methodically deal with those who think they are too big to fail. We must make sure that they are not.

So I am just opening it up to the panel. Yes, Congressman English.

Mr. ENGLISH. I will take a crack at that. Some of our members have formed and gone together, because we are so small, with our own entity we have created and we own it that does these kinds of hedging for our membership. We did take a look at—earlier this year, we had about 18 of our members who were, in fact, hedging, and if they had gone to a clearing device that they would have to, in order to meet these requirements, they would have likely had to come up with about $300 to $400 million in order to cover what we would anticipate would be the margin cost. If you look at that at about five percent, you are talking about roughly somewhere in the neighborhood of $15 million that those 18 entities would have to incur in additional expense.

We do have some of our trades that are on the exchanges, so it is not that everything is over-the-counter. Most are, and this is the primary reason for it.

Chairman LINCOLN. Thank you.

Mr. SCHLOSS. I guess I will cover a couple of the questions that you asked, because I think the cost comparison one is one that, from a transaction-specific base, we all in the case of over-the-counter derivatives pay a credit charge up front from the standpoint of the unique credit charge. So how would that compare to what it would actually cost if you did to go an exchange, I think is yet to be seen if you go that way from the standpoint of the market development.

I think for end users, and in our case specifically, the margin requirement that would come from a standpoint of not only the upfront margin for every transaction, but as you heard earlier today, as you go in time, the market value of that transaction changes, so the posting of margin changes. And going through an exchange will tie up valuable working capital, which for us is a tradeoff between margin versus product programs. You know, a half-a-billion dollars of margin could be a very significant new product from the standpoint of our ability to stay competitive, not only domestically, but against foreign competition. So I think there is a cost of that capital and an alternative use for that capital that is very important for us.

As you get into defining end users, and I recognize the problem that you all face, because everybody is going to be here talking about why they need exemptions, and end users all have a different flavor for why they need it, our—and the problem that we all have is that we are a very small piece of the market from the standpoint of the overall over- the-counter market, and there have been studies that we make up something about ten to 15 percent of the overall market.

The end users from our perspective, or from Ford's perspective, clearly will center around who are the market makers versus who

has the underlying business risk. We use over-the-counter derivatives to hedge an underlying business risk that is generated from either selling of cars made domestically and shipped foreign or vice-versa, interest rate hedging from a standpoint of our ability to continue to fund our customers and our dealers. So there is an underlying business risk that if we aren't able to hedge or aren't able to hedge effectively, we are making a risk tradeoff from the standpoint of our overall business.

So I think those are our two points very specific to Ford from the standpoint of both end user as well as cost.

Mr. BOLING. To answer your questions in kind of reverse order, Southwestern hedges its natural gas price risk using two different types of derivative instruments, over-the-counter swaps and costless collars. And both of those instruments require no initial net investment payment up front to Southwestern.

With respect to what would happen if the clearinghouse requirements were in place as has been proposed by some legislation, we did our own internal estimates, and if you estimated if they were in effect June 30, 2008, if the clearinghouse margin requirements had been in place, we would have been required to post $740 million in cash margin. But by the end of the year, that would have changed because of the volatility in prices down to $118 million at year end 2008.

And just to put these numbers in context, as of December 31 of 2008, our company's total debt outstanding was $735 million. So these clearinghouse requirements and the margin requirements would have required us to come up with additional money somewhere of $740 million.

Mr. BILLINGS. On the cost issue, and our hedging is very much, as the other gentlemen here have described, we are hedging future gas costs for our municipal members and ultimately their customers. We deal primarily in the over- the-counter market. We also have no collateral arrangements, and so not required to post collateral when we hedge.

As far as the costs go, a couple of things. Chairman, on your point about bid-offer spreads, I don't know that I have seen anything—it sounds good in practice, but I don't know that I have seen anything to convince me, anyway, that we are going to see a big change in bid-offer spreads just because we force everything to clear. It is possible.

From a cost standpoint, when we go out to do a hedge— and I am in these markets every day—when we go out and do a hedge, I may pay a half-a-cent or a cent per MMBtu over the stated bid or offer on the exchange to trade over-the-counter. That is a very minor cost for us. We are very comfortable with that cost. We have several counterparties we deal with. I can try to work that cost down through competition.

On the other side, now, if I am forced to clear everything, we are going to have a large line of credit in place. We don't have a large amount of cash on hand. This really is going to change what we are doing, and so we are going to have to go out and get a big line of credit. Our estimate, we weren't exactly sure what standardized meant, so I took a look at if we had to clear every swap that we have on our books and had to have enough cash on the side for

maintenance margins, we estimated we could have possibly up to a $500 million line of credit that we would have to have. Just having the line of credit, 50 to 75 basis points. Using it, and then we are talking about, as Mr. English said, five percent, those dollars add up quickly. We estimated it could be as much as $10 million per year of additional cost.

So for me, it is very simple. The cost of having a line of credit far exceeds anything that I could see in improvements in the bid-offer spreads.

And then we also—we are concerned that having to put a big additional debt on our balance sheet could impact our credit rating, so it could have trickle-down effects in other things that we do, if we are trying to do infrastructure updates or help a system reach a new customer. Anything where we have to issue debt, if the rating of that debt is impacted by this large line of credit that we might have to have, there are other impacts to our systems that we are very concerned about.

Chairman LINCOLN. Dr. Johnson.

Mr. JOHNSON. First of all, let me start by saying that I am much less intimately familiar with the individual businesses of each of the gentlemen to my right. So I don't think—to dispute them regarding the individual costs, I just have no basis for that.

As I say in my written testimony, I do believe that we have had a system that has been reliant upon the guarantees of the taxpayers via the marketplace that was the "too big to fail" institutions, and we have had underpriced insurance. And as each of them discusses, the change to an exchange or to a clearinghouse would in all likelihood entail—the process of obtaining that insurance would be more costly for each of them. It would be more costly in the cash management realm. Some would go without insurance and the consequences would likely be diminished profits in their sector or at their firms and it would also likely be the case that their pricing, they would pass through to their customers and they would bear some of that burden.

But philosophically, what I am saying is that is a removal of a subsidy, and it might have even been what you might call an implicit design, not something that we all sat down and said, we want to subsidize this credit. We just have revealed in light of episodes that that is the case.

I would anticipate, if you moved to exchange trading, that we would experience a narrowing of bid-ask spreads, more transparency of market prices, and an integrity of the system, which would also diminish the contingency of a big wipe-out-like crisis that we just had, and that indirectly should be factored into their costs. The collapse of demand, the layoffs, and all of the other things that all of our firms and our society are adjusting to right now, in my opinion, dwarf the kind of calculations that we are talking about today, however real they happen to be.

Chairman LINCOLN. Thank you.

I have to apologize. I have gone way over my time and I need to defer to my colleague, Senator Chambliss, to move on. Thank you.

Senator CHAMBLISS. All of you have heard the previous discussion we have had about transparency and moving towards a dif-

ferent form of reporting requirement. Whether it is a clearinghouse for all transactions or not obviously is still going to be up for debate. But from the standpoint of each of you four, if we required full transparency of all transactions, irrespective of whether you have an exemption or not, is there any issue with doing that? I mean, are all of you willing to be fully transparent about the swaps and derivatives that you enter into? Glenn?

Mr. ENGLISH. Yes.

Mr. SCHLOSS. Absolutely.

Mr. BOLING. Yes.

Mr. BILLINGS. Yes, without question. We have been in favor of more transparency for many years.

Senator CHAMBLISS. All right. The question that I was getting to with Chairman Gensler, I think I finally understood his answer, and that is as each of you deal with the respective financial institutions or sellers of products or whatever it may be, if you have the benefit of the full transparency of all of their transactions prior to your engaging them in a swap or a derivative, would the information that you could glean as a result of knowing their financial position and their capital position affect your ability to make a decision on whether or not it would be a prudent investment for you to engage with that company? Glenn?

Mr. ENGLISH. Yes.

Mr. SCHLOSS. I think to the extent that we could get more transparency into the credit charges, I think that would be a help. The market itself is pretty transparent already. There are plenty of market screens from a standpoint of knowing where transactions trade. The difficulty will come when you have a very specialized trade, in our case, the securitization world, which takes on a very unique piece of the asset. Transparency in those transactions, even if everything was reported, I am not sure would add a whole lot of value.

Mr. BOLING. Our company has a formal commodity risk management policy, and as part of that policy, we engage in analysis, credit analysis of all the counterparties that we use, which at this time is, I believe there are 13 different counterparties. So that is an ongoing thing for us because we are concerned about their particular credit exposure in making sure it is spread across a number of different counterparties, as well as making sure of the financial integrity of each counterparty. So anything that would allow us to do that job more effectively, we would support.

Mr. BILLINGS. I really agree with Mr. Boling, that anything that helps shed light on potential red flags—we talked about AIG earlier—anything that would throw off concern that one of our counterparties was undercapitalized would certainly help us on the front end make decisions about whom we are trading with, so very much so.

Senator CHAMBLISS. Well, Dr. Johnson makes a good point about they fact that we need to make sure that there is security in the market, and it is like buying an insurance policy. I think that is a pretty good analogy that has been used several times today.

But what I am concerned about is the practicalities, having been in business myself, the practicalities that each one of you have alluded to. In fact, you, Mr. Billings, have indicated that there are

no liquid assets that your members could put up basically to provide for security or non-cash collateral assets or cash collateral assets. And even if you had to put up cash, it is going to severely hamstring you.

But when we modernized the CEA in 2000, we thought we were doing the right thing, and I think we did do the right thing, to put more flexibility in the marketplace. But what we didn't anticipate was the ability of the players in the market to package CDSs, for example, and do it the way that, say, AIG did it. And where I come down on Dr. Johnson's side is just trying to make sure that as we move forward with whatever legislation we wind up with, that we don't create an opportunity for additional CDSs to collapse the market ten years from now. So I think that is what we have got to be careful of.

I am not concerned about any of the full review. You all have got folks you have got to answer to and you have got smart people doing your business. But the folks who caused this collapse were out there getting greedy and making a lot of money and trying to make more money, and they weren't going to make it off folks like you all, but they are going to make it off of some people who are not as savvy or not as sophisticated as the four entities we have got here today.

So I think our job is going to have to be where do we find that middle ground without requiring, Mr. Boling, you put up as much for a line of credit as you have in total outstanding debt. That makes no sense at all. But yet, we need to make sure that there is that security in the marketplace for that operator down the line who may be third or fourth removed from you as an ultimate customer to make sure that there is no collapse in the intervening transaction that is taking place.

That is why this is such a complicated issue and why I am really glad that the Chairman has held this hearing today, because I think all of you provided valuable information that we are going to have to take back and digest and see if we can't find that common ground that is going to allow you to continue to operate.

And Glenn, I guess I am more familiar with your folks than anybody else because I know your members are all nonprofit and they are made up of farmers and ranchers and small business people, primarily, who can't afford the kind of cost that is going to be put on them from the standpoint of having to secure all of these transactions. And since I am a consumer of yours, too, I don't want my utility bill going up.

And the same thing with Mr. Billings there. He is serving Georgia.

But all of you have provided very valuable practical information for us to digest and I thank you for being here and giving us that testimony today. It is going to help you through this period. We look forward to staying in touch and dialoguing with you about the issues that we are going to continue to see develop as we go through this process. Thank you.

Chairman LINCOLN. Senator Conrad.

Senator CONRAD. Thank you, Madam Chairman.

First of all, let me say this is an excellent panel, really five outstanding witnesses. All of you have contributed to the work of this committee in a very positive way and we appreciate that.

What strikes me about this conversation is transparency, as I see it, is necessary but not sufficient. In the case of AIG, as my memory serves me, one of the big financial houses wanted to go from ten-to-one leverage to 30-to-one leverage. They knew there was inherent risk in moving to that kind of leverage. If everything is going well, you make a lot more money. If things are not going well, you lose a lot more money.

And so they recognized the need for an insurance product and they went to AIG and convinced them to write such insurance products, and AIG saw a gift horse and said, oh, yes, we can make a lot of money on this deal. What they forgot about is having the resources to cover against the down-side risk of these transactions. And when the down- side risk occurred, here we go. Taxpayers were the ultimate funder of the liability. That, we cannot permit to happen again.

Dr. Johnson, thank you for your testimony. I think it was very clear and compelling.

The one thing that strikes me is, as legislators, we have got an obligation to differentiate those places that are contributors to systemic risk, those that are not, and somewhere in between, because if we try to impose a regime on everyone and some of them are in a different category, we won't get anything done. I would say that to you. That is the trick of legislating.

As I listened to the first four witnesses, I have high regard for Congressman English. He was the Chairman of a subcommittee in the House Agriculture Committee when I chaired the comparable committee on this side. I can tell you, he is one of the smartest and tough negotiators I ever dealt with around here. No, I said that wrong. I said smartest and toughest. Toughest and smartest.

[Laughter.]

Senator CONRAD. When I listen, he is a smart guy. I don't think those kind of transactions contribute much to systemic risk.

Mr. Schloss, as I listen to your description, that does not strike me as in the same category at all of what the hedge funds were doing or what certainly AIG was doing, which I believe was criminal. I believe some of those people ought to go to jail.

Mr. Boling, I thought you were very persuasive. Mr. Boling, you used a phrase there on exemptions. You used language there about hedging transactions. I would like to go back and have you just reread that specific language, where you were proposing an exemption. For those who are hedging transactions, people who are hedging real business transactions, I think is what you were getting at, rather than, you know, speculation. Do you have that? Can you——

Mr. BOLING. I believe I can identify—I believe it was under the—was it at the beginning of my remarks or at the end where we were making recommendations?

Senator CONRAD. You were making recommendations and you were proposing where you would draw a line with respect to exemptions——

Mr. BOLING. Yes.

Senator CONRAD. and you were describing that. I don't have all the words. I wrote down, hedging actual transactions.

Mr. BOLING. Yes. I believe the language is Southwestern believes the solution to these problems would be to provide an exemption from the clearing and margining requirements for bona fide hedging transactions where at least one party involved is a company that produces, owns, and sells, or purchases and consumes, the commodity, and the transaction is directly related to managing commodity pricing risk inherent to that company's operating activities. We believe these transactions are easily distinguishable from those that are purely speculative, which appears to be the primary focus of the proposed derivatives legislation.

Senator CONRAD. In a nutshell, to me, you summed it up with that statement. And it seems to me that that is something we have got to try to capture here, and I would ask Dr. Johnson—and Mr. Billings, thank you for your testimony. It was very clear. You are in a situation, you don't have a lot of cash. Whether it is $500 million or $250 million doesn't make that much difference. The point is, you would have to, if you are running it through clearing, come up with additional money that you would have to finance somehow. Clearly, that would add to cost.

Dr. Johnson's point is, yes, but there is risk in any of these, and certainly there is risk. I mean, we have to acknowledge that, not nearly the risk in these transactions that I see in what I saw hedge funds doing, what I saw AIG doing. Would you acknowledge, Dr. Johnson, there is a difference between what some of the hedge funds were engaging in, what AIG was engaging in, and what these companies have been doing?

Mr. JOHNSON. Well, first of all, Senator, there clearly is a difference, and to echo Chairman Lincoln's comment earlier about how to construct an exemption, I was trying in my testimony to warn against creating hard and fast rules that then we might say lawyers can navigate around and leave us where Senator Chambliss talked about with AIG, which was with a disaster that was never the intention of the committee in the year 2000. So what I would recommend is to see someone like Chairman Gensler as the referee, as the arbiter.

The gentleman sitting to my right, Mr. Billings, talks about the various cash flow problems, and no one has any intention to drastically impair his business. That is not healthy. So the kind of exemption that he would seek is something that someone with expertise who could differentiate between a hedge fund and his type of risk and his type of business structure could make a determination that it was in the public interest.

And while—how would I say—I characteristically am more in favor of rules that are clearer than in allowing regulatory interpretation, because, as you know, the nature of who is in that regulatory chair changes, and that creates a volatility that these men probably don't appreciate.

Senator CONRAD. Sure.

Mr. JOHNSON. But I think in this instance, because of the complexity of derivative markets, I would opt for the exemption arbiter, if you will, to be the Chairman of the CFTC.

Senator CONRAD. All right. Thank you. My time has expired.

Chairman LINCOLN. Senator Lugar?

Senator LUGAR. Dr. Johnson, let me go back to the question I raised with Chairman Gensler about AIG and the insurance that was being sought by the banks that had finally packaged together all these residential loans. I gather from your testimony, AIG could have charged a higher fee to these banks for the insurance they were seeking. If I listened to you carefully, AIG was offering a subsidy, of sorts. The subsidy ultimately was paid for by the American people in the collapse of the system. In other words, by offering these derivatives for lower costs than really the type of insurance that was required, and AIG not having the resources to pay, should they collapse, this huge subsidy, ultimately caused this catastrophe that we continue to go through with all of the rescue efforts.

In this particular situation, how do we require AIG to charge the proper amount? In other words, where is the market? Is this something up to Mr. Gensler, as the referee, saying you are underpricing this derivative. It ought to be much higher, or all of us are likely to have systemic risk.

At the other end of the situation, as you listened to the other four on the panel, you said you understand they have cash problems, and these are small situations in comparison to what we were talking about with AIG. Trying to find an exemption as to who comes underneath this—after all, someone at AIG or some equivalent company may be clever enough, to sneak underneath the tent with those who are being exempted now. You are saying perhaps the response we ought to have is not to try to do in legislative language the precise exemption, but to have Mr. Gensler or somebody like this as a referee, or as an arbitrator, who has the expertise, who has the staff, who says, "no, you folks really don't qualify as agriculture cooperatives or natural gas firms or so forth. You are something else."

I am just trying to figure this out, because I like your idea that somebody pays ultimately. If we had no exemptions, then the small businesses here today could say, "if we are going to hedge on behalf of our customers and so forth, this is going to cost money. We don't have a whole lot of cash. It ultimately has to be passed on to the customers." But if it is not passed on to the customers and risks are taken, then the customers are getting a subsidy in terms of what they ought to be paying to begin with for the natural gas or for whatever else they are buying for.

We are more sympathetic with householders and so forth as customers than we are with large entities who are getting the subsidies from AIG. I am curious, how do we construct this legislation so that the subsidy, if it is there, and is clear, how do we extract the subsidy out of it? Because at the end of the day, why, none of us really are thinking of subsidy. We are thinking now of the bailouts of the stimulus package, and how are going to pay for it forever, even if we are very small individual consumers given the billions and trillions that we are borrowing. That is going to be the ultimate result of this if it is not done right to begin with.

How do you spot the subsidy and how do you make sure it is not a part of the process?

Mr. JOHNSON. You ask me easy questions.

[Laughter.]

Mr. JOHNSON. I think that in the case of AIG—I will start with where you started—what was fundamentally missing was an equivalent of a supervisor or a regulator that understood that they were providing what I will call mirage capital. They were providing assurances through the credit default swap market to the other "too big to fail" institutions, as well as others, but it was a mirage in the sense that they were not setting aside the resources to be able to meet those claims contingent on an event called a default.

Senator LUGAR. Is this fallibility, then, of the President or whoever appoints these regulators? How do we know that the person that is appointed is going to be bright enough to understand?

Mr. JOHNSON. Well, that was the next stage, which is the first piece you need is for them to be regulated. We have insurance companies that are dealing in these actuarial odds regarding property, casualty, life insurance, and other things, earthquakes and what have you. You are never sure what the odds are. The past is not always prologue, and we had an extreme outlier in this episode.

The second—but at some level, somebody should have been there, calling on AIG and saying, how come you are paying out bonuses and recording this as income and paying dividends and not provisioning for these losses? What was called a credit default swap to avoid regulation was actually credit default insurance.

The second thing to diminish that is that I would stop uninsurable risks. People shouldn't buy insurance on something they don't own. So that is what fomented the speculation there.

With regard to designing the structure and where the subsidy lies, what they call the lemon socialism, the downside is ours and the upside is private, it really has been the architecture of the banking system and the acknowledgement that the spillovers from the banking system can harm the real economy that has been the basis for that safety system. So I would return to that "too big to fail" regime and the design of the systemic regulator.

With regard to your specific task—and what I think is really fascinating is that the interaction between derivatives and "too big to fail" is going to put you into a joint venture with the Banking Committee, and keeping the derivatives simple, transparent, supervised, and provided for with capital and margin will diminish the extent to which they can spill onto the banks. And one thing I might recommend in legislation is over in the Banking Committee in their "too big to fail" determinations, they are going to speak about tier one financial institutions, or systemically significant institutions, and I would very much consider— and I would be interested in each of your thoughts on this— if you go to a tier one classification, your legislation could have an exemption which says—or have a provision which says no one is eligible for an end user exemption in any subsidiary, affiliate, branch, or whatever who has been designated a systemically significant institution, and that way you would avoid this attempt to drive, as I call it, the jet plane through the loopholes of language.

Senator LUGAR. Thank you very much.

Chairman LINCOLN. Thanks, Senator Lugar.

Thanks to all of you all for joining us, and I think, actually, Senator Chambliss has one more question.

Senator CHAMBLISS. Yes. I have one for Mr. Schloss. I want to drill down on one particular issue that is important. That is, you indicated in your written testimony that your interest rate swaps are over-the-counter customized derivatives, and some have claimed that interest rate derivatives are an example of standardized swaps that can easily be cleared. Could you describe why you consider these to be customized as opposed to standardized?

Mr. SCHLOSS. Great question, Senator. There are really three pieces, or three types of interest rate derivatives that we will use. The biggest one by far is the securitization swaps, which are done between the securitization trust and the counterparty from the standpoint of protecting the underlying investor. And a great example is when we do a retail contract to consumers, those are typically done on a fixed-rate interest rate. We package hundreds of thousands of those together and sell them to investors that are typically floating rate buyers. So we have to hedge that interest rate, but they are amortizing structures and they are very unique to the underlying asset class. So that is probably over half of our interest rate derivatives are done in that form.

The other piece is when we do a long-term debt instrument and we try to fund the business longer than our assets, so if we do a ten-year bond, our assets are three years, we need to match those terms of the bond specifically in order to get FAS 133 hedging treatment. So those have to be very unique from the standpoint of matching the exact same terms of the bonds.

The other piece of our interest rate hedge are more common from the standpoint of taking floating rate to fixed on a more standardized basis.

Senator CHAMBLISS. And again, I am assuming from your earlier answer, even if you had an exemption, there is no problem with you disclosing all of the financial transactions involved in those derivatives——

Mr. SCHLOSS. No problem whatsoever.

Senator CHAMBLISS. —to the CFTC. Thank you.

Chairman LINCOLN. Well, thanks again to the panel. You, as the members have said, you have been most helpful to us in the deliberations. We appreciate your testimony and certainly would ask that you not go too far because we would love to be able to continue the conversation as we move legislation through the committee and have deliberations on how to do a good job putting this together.

I would remind people that we are going to have a second hearing on December 2nd, Secretary Geithner will be on our first panel there.

Thank you all for joining us. We appreciate it. We look forward to continuing to work with you to solve the problem. Take care.

[Whereupon, at 12:25 p.m., the committee was adjourned.]

A P P E N D I X

NOVEMBER 18, 2009

SENATOR BEN NELSON'S STATEMENT FOR THE RECORD FOR THE

SENATE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
FULL COMMITTEE HEARING

Reforming U.S. Financial Market Regulation

Wednesday, November 18, 2009 —9:30 am
106 Dirksen Senate Office Building

Thank you, Ms. Chairman. My compliments to you and Ranking Member Chambliss for holding this hearing on a very complicated, but very important topic. I look forward to working with you and our colleagues on this committee as we play our role in the debate over derivatives regulation. Without a doubt, the financial crisis of last year compels us to act in this area.

I come from an insurance background, so capital and solvency regulation is second nature to me. In the insurance business, if you make a promise, a regulator is going to be standing right behind you making sure you have the resources to back it up.

While recognizing there are differences in the two markets, there are also a lot of similarities. As such, it seems to me that increasing transparency in the market via trade reporting and other disclosure requirements is a given as common-sense reform. While getting capital behind these contracts is a trickier issue, I believe it should be examined as a vital tool for the stability of our financial system.

I think we should do all this while recognizing and preserving the benefits of the derivatives market; we should have regulation without strangulation. We need to be mindful of and work to address the input and concerns of the companies who have used the over-the-counter market as a successful hedging tool for years. We must not regulate in a vacuum - we need to consider the economic impact and the global nature of these markets.

In addition, we must be careful of any regulatory changes that would impact the economics of existing contracts. While existing swaps should be subject to transparency provisions, such as reporting requirements; we should ensure that new regulations should be prospective in their scope and not subject existing contracts to clearing requirement, and margin and capital requirements.

Legislation on derivatives will need transition rules for existing contracts in order to provide legal certainty, to avoid serious disruption in the marketplace, and to avoid litigation concerning the diminished value and potential increased costs to private parties of these contracts. Absent transition rules, new legislation could place new and costly requirements on parties to existing contracts and may lead counterparties to demand an adjustment in pricing or declare a regulatory "out" or illegality and void certain contracts, which could lead to higher transaction costs or termination payments.

Precisely the kind of disruptions the new legislation is trying to avoid.

Despite these challenges I look forward to working with my colleagues to provide transparency and get the adequate amount of capital behind derivatives contracts to control the risk the market poses to the financial system, and as we have unfortunately learned, the American taxpayer.

TESTIMONY OF JEFF BILLINGS

MANAGER OF RISK MANAGEMENT FOR

THE MUNICIPAL GAS AUTHORITY OF GEORGIA ON BEHALF OF

THE AMERICAN PUBLIC GAS ASSOCIATION

BEFORE THE HOUSE AGRICULTURE COMMITTEE

NOVEMBER 18, 2009

Chairman Lincoln, Ranking Member Chambliss and Members of the Committee, I appreciate this opportunity to testify before you today and I thank the Committee for calling this hearing on reform of the over-the-counter derivatives market. My name is Jeff Billings and I am the Manager of Risk Management for the Municipal Gas Authority of Georgia. The Municipal Gas Authority of Georgia is the largest non-profit natural gas joint action agency in the United States. We have 76 public gas system members in five states: Georgia; Alabama; Florida; Pennsylvania; and Tennessee. Together, these systems meet the gas needs of approximately 243,000 customers.

I testify today on behalf of the American Public Gas Association (APGA). APGA is the national association for publicly-owned natural gas distribution systems. There are approximately 1,000 public gas systems in 36 states and over 720 of these systems are APGA members. Publicly-owned gas systems are not-for-profit, retail distribution entities owned by, and accountable to, the citizens they serve. They include municipal gas distribution systems, public utility districts, county districts, and other public agencies that have natural gas distribution facilities.

APGA's number one priority is the safe and reliable delivery of affordable natural gas. If we are to fully utilize clean domestically produced natural gas at long-term affordable prices, we ultimately need to increase the supply of natural gas. However, equally critical is to restore public confidence in the pricing of natural gas. This requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, abusive market conduct or excessive speculation.

Over the past several years, and leading up to the passage of the CFTC Reauthorization Act, APGA has sounded the alarm with respect to the need for greater oversight and transparency of the over-the-counter markets ("OTC") in financial contracts for natural gas. APGA previously testified before the House, Senate and Commodity Futures Trading Commission (CFTC) that APGA's members had lost confidence that the prices for natural gas in the futures and the economically linked OTC markets are an accurate reflection of supply and demand conditions for natural gas. APGA further testified that restoring trust in the validity of the pricing in these markets requires a level of transparency in natural gas markets which assures consumers that market prices are a result of fundamental supply and demand forces and not the result of manipulation, excessive speculation or other abusive market conduct. APGA therefore strongly supported an increase in the level of transparency with respect to trading activity

in these markets. For this reason, APGA strongly supported the recent enactment of the CFTC Reauthorization Act of 2008 .[1]

The Reauthorization Act

APGA believes that the increased regulatory, reporting and self-regulatory provisions relating to the unregulated energy trading platforms contained in the CFTC Reauthorization Act of 2008 was, and is, a critically important step in addressing our concerns. We commend this Committee for its work on the Reauthorization Act. The market transparency language that was included in the Reauthorization Act will help shed light on whether market prices in significant price discovery energy contracts are responding to legitimate forces of supply and demand or to other, non-bona fide market forces.

APGA also notes that the CFTC, under the leadership of Chairman Gensler, has taken many significant steps to address the concerns raised by APGA, exercising the new authority provided under the Reauthorization Act and its existing administrative authority under the Act. For example, the CFTC has exercised the authority given it in the Reauthorization Act, finding that the LD1 natural gas contract traded on the Intercontinental Exchange, Inc. is a significant price discovery contract[2] and is thereby

[1] Food, Conservation, and Energy Act of 2008, PL 110-246, 122 Stat. 2189, Title XIII.
[2] See "Order Finding That the ICE Henry Financial LD1 Fixed Price Contract Traded on the Intercontinental Exchange, Inc., Performs a Significant Price Discovery Function," 74 *Fed. Reg.* 37988 (July 30, 2009) . Since July, the CFTC has issued a number of orders finding additional contracts to be significant pirce discovery contracts..

subject to the enhanced regulatory requirements of the Reauthorization Act. It also is providing enhanced transparency through its Commitment of Traders Report and is using its special call reporting authority aggressively in connection with OTC contracts. In addition, the CFTC has formed and continues to seek advice of an energy markets advisory committee. Many of these steps were first recommended by APGA. APGA believes that all of these enhancements have been important steps in addressing the problems faced by the markets in natural gas.

Need for Additional Legislation

As APGA has stated in prior testimony, we believe that it is necessary for Congress to provide the CFTC with additional statutory authorities and adequate resources to respond fully and effectively to the issues raised by trading in the energy markets. Specifically, additional transparency measures with respect to transactions in the OTC markets are needed to enable the cop on the beat to assemble a full picture of a trader's position and thereby understand a large trader's potential impact on the market.

APGA is supportive of the approach taken in H.R. 3795, The Derivative Markets Transparency and Accountability Act of 2009, recently reported by the House Agriculture Committee. We believe this legislation offers Congress a constructive basis for addressing many of the issues that remain open following enactment of the Reauthorization Act. Specifically, APGA is strongly supportive of provisions in the legislation requiring reporting by large traders of OTC positions and the application of aggregate speculative position

limits. APGA believes that these regulatory tools to enhance transparency, and to limit excessively large speculative positions, are a critically important step in effectively and fully addressing the issue we have raised with respect to pricing anomalies in the natural gas market and complete the work begun in the Reauthorization.

Mandatory Clearing.

APGA also strongly supports the statutory exemption in H.R. 3795 for end-users from the mandated clearing of OTC contracts. There are currently several proposals under consideration in Congress that differ from H.R. 3795 in that they would mandate the clearing of all standardized OTC transactions regardless of the nature of the customer. Mandated clearing would have a significant impact upon public gas systems and their customers. Specifically, requiring public gas systems to clear their OTC transactions would increase their cost of hedging and as a result, subject their natural gas customers to higher prices for natural gas. Or, the increased cost of hedging may result in natural gas systems reducing their hedging transactions, subjecting their customers to greater price volatility and again, increasing the cost of natural gas to their customers.

Public gas systems depend upon both the physical commodity markets as well as the markets in OTC derivatives to meet the natural gas needs of their consumers. Together, these markets play a critical role in these utilities securing natural gas supplies at stable prices for their communities. Specifically, natural gas distributors purchase firm

supplies in the physical delivery market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates. By using both markets, these public gas systems are able to purchase firm deliveries of natural gas from a diverse set of suppliers while hedging the risk of future market price fluctuations.

However, proposals that would require all standardized OTC derivatives transactions to be cleared would significantly impair the financial ability of public gas systems to engage in these gas supply strategies. Under current practices in the OTC markets, many public gas systems based upon their very-high credit worthiness are not required to post collateral as long as a gas system's exposure stays below a predetermined threshold. Moreover, adjustments to collateral levels are made on a pre-defined, periodic basis. This is particularly suitable to the routine funding and fee collection practices of public natural gas distribution systems. In contrast, the mandated clearing of all OTC transactions would require public gas systems to post initial margin for all transactions and to hold money in accounts to meet potential margin calls whenever required on little notice. This would constitute a significant financial and operational burden on these systems, their communities and their consumers. Moreover, the proposed mandate to clear all standardized OTC derivatives transactions would increase costs for public gas systems and their municipalities; an increase which would be borne 100% by their consumers.

By way of example, in the case of the Municipal Gas Authority of Georgia, we have determined that based on our current hedge positions, mandatory clearing would require us to post initial margins in the range of $163 million to $243 million. The following table shows how we developed this calculation:

Type of Hedging	**Volumes Currently Hedged (MMBtu)**	**Contract Equivalent (Contract = 10,000 MMBtu)**	**Initial Margin Requirement at $5,000/Contract**	**Initial Margin Requirement at $7,500/Contract**
Residential, Commercial & Industrial Load	38,883,000	3,888	$ 19,440,000	$ 29,160,000
Storage Gas	6,140,000	614	3,070,000	4,605,000
Long-Term Supplies*	278,374,000	27,837	139,187,000	208,780,000
Basis Swaps**	27,410,000	10,964	2,741,000	2,741,000
Total	350,807,000	43,303	$ 164,438,000	$ 245,286,000

* Long-term supplies include hedges associated with 15 and 20 year firm supply prepayments and acquisitions of natural gas reserves.

** Basis swaps assume a contract equivalent of 2,500 MMBtu per contract.

You will see in the above table that two different estimates for the initial capital requirement were considered-- $5,000 per contract and $7,500 per contract. The initial capital requirement for a NYMEX contract (10,000 MMBtu) is currently $4,000 per contract. However, NYMEX adjusts this capital requirement based on the overall price of natural gas and volatility. When natural gas prices hit their peak last year, the initial capital requirement was over $10,000.

In addition to the initial capital requirement, the clearing exchanges can and do require additional capital contributions based on daily mark-to-market calculations which account for fluctuations in the price of natural gas. For this reason, we would have to obtain a line of credit substantially larger than the initial capital requirement range of $163 million to $243 million to be prepared to cover capital calls resulting from a change in natural gas prices. Assuming an overall line of $500 million for our hedging activity with $200 million funded for the initial capital requirement, the added borrowing costs for our organization could easily exceed $10 million per year (based on the average interest rates of the past 5 years).

When spread over our members annual volumes, this added borrowing costs amounts to approximately 25 cents on every MMBtu delivered. This cost increase is the equivalent of doubling the cost of interstate pipeline transportation per MMBtu or raising distribution rates over 10 percent. As has been discussed previously in our testimony, this substantial increase in cost to the consumer comes without any benefit.

It has been suggested that the clearing requirements would be less burdensome if some end-users are given the option of posting non-cash collateral. Unfortunately, the alternative of using non-cash collateral would not provide any relief to public gas systems. Public gas systems generally are prohibited by their constitutional documents from pledging as collateral the components of their physical infrastructure, such as pipelines. Accordingly, public gas systems would only be permitted to pledge non-cash

collateral in the form of liquid assets. However, public gas systems simply do not maintain such liquid assets in the quantity necessary to meet the requirements associated with clearing. And maintaining this level of liquid assets would be at odds with their routine funding operations.

Another result of mandatory clearing would be the de facto elimination of the use of tax-exempt financing for the prepayment of long-term natural gas contracts, also known as "prepays." Prepays were endorsed by Congress as part of the Energy Policy Act of 2005 and have been a key tool that public gas systems, including the Municipal Gas Authority of Georgia, have used to secure long-term, firm supplies for terms up to 30 years. One critical component of the prepay is an OTC swap transaction that enables the public gas system to ultimately pay a price discounted below the prevailing spot market price. Importantly, the OTC derivatives utilized in prepays are "tear up" agreements, that is, they terminate at no cost in the event the prepay terminates. Because of their size and long-range nature, requiring clearing of the prepay swap would be cost prohibitive, thereby eliminating a tool public gas systems have utilized to lock into long-term supplies of natural gas and protect our consumers from price volatility.

Accordingly, APGA strongly rejects the suggestion that all OTC derivatives be required to be cleared regardless of the nature of the end-user counterparty. That suggestion, if enacted into law, would constitute a significant financial and operational burden on publicly owned natural gas distribution systems, their communities and their consumers, and would not address the systemic risk problems which have brought about

the current financial crises. From our perspective, the continued availability of individually negotiated, non-cleared OTC transactions will provide public gas systems with the widest range of tools to continue to offer natural gas at the best possible prices to their customers. The customers of public gas systems reap the benefits of these arrangements through lower rates for the natural gas which they purchase. The hedging of natural gas supply purchases by public gas systems using non-cleared bi-lateral OTC derivatives do not present the types of systemic risks posed by some dealers of credit-default swaps, which is the impetus behind the proposed clearing mandate. For this reason, APGA supports the approach of the House Agriculture Committee in requiring those exempted end-users to demonstrate to the CFTC that their transactions are for legitimate hedging purposes.

Accordingly, as Congress considers reform of the OTC derivatives markets APGA strongly supports the inclusion of a statutory exemption from mandatory clearing for hedgers that are not major swap participants. To do otherwise, and to require non-systemically important end-users that enter into OTC transactions for hedging purposes to clear their OTC transactions is in essence punishing the victims of the recent financial crisis.

* * * * *

Natural gas is a lifeblood of our economy and millions of consumers depend on natural gas every day to meet their daily needs. It is critical that the price those consumers are paying for natural gas comes about through the operation of fair and orderly markets and through appropriate market mechanisms that establish a fair and transparent marketplace. However, it is equally important that efforts to reform financial markets allow end-users, such as public gas systems, to continue to use the over-the-counter markets without incurring additional costs to hedge risk. APGA looks forward to working with the Committee to accomplish that goal.

Testimony

Before the
United States Senate
Committee on Agriculture, Nutrition & Forestry

On

Reforming U.S. Financial Market Regulations

Mark K. Boling
Executive Vice President and General Counsel
Southwestern Energy Company

November 18, 2009

Good morning Madam Chairwoman and members of the Committee. My name is Mark Boling and I am Executive Vice President and General Counsel for Southwestern Energy Company, an independent energy company that is primarily engaged in natural gas exploration and production within the United States.

I appreciate the opportunity to appear before you today and provide testimony regarding the very important legislative effort to reform the over-the-counter (OTC) derivatives market.

One of the biggest challenges in enacting legislative reforms for the OTC derivatives market is that the term "over-the-counter market" covers a vast array of products across a number of markets, thereby making it extremely difficult to implement an effective "one size fits all" legislative solution. In this regard, it is important to note that energy derivatives did not cause the financial crisis of 2008 – credit default swaps and subprime mortgages did. It is also important to note that while we have witnessed the greatest economic crisis in 80 years, and perhaps the most volatile commodity market Southwestern has ever experienced, OTC derivatives in the energy markets performed well, did not create systemic risks, and in fact helped many end-users manage and hedge their risks during this very difficult time of extreme volatility. We support all legislative efforts to improve the transparency and stability of the OTC derivatives market and to ensure market integrity by preventing excessive speculation, manipulation and other abusive practices. However, we believe that any such legislation must recognize the significant differences between the various derivative markets and make a clear distinction between those market participants that engage in hedging transactions with the goal of managing the price risk inherent in their business and those market participants that engage in speculative transactions with the goal of achieving profits through the successful anticipation of price movements.

My testimony today will focus on four things:

- Why OTC swaps are so important to independent energy producers like Southwestern;
- The impact on Southwestern and other independent energy producers if they are required to clear or post cash margin for their hedging transactions;

- Southwestern's recommendation for the treatment of hedging transactions; and
- Southwestern's support of market transparency and reporting.

Why OTC swaps are so important to independent energy producers.

Southwestern Energy Company (NYSE: SWN) is a growing independent energy company. Since 2005, Southwestern has invested over $6.5 billion in its operations, all of which are located in the United States. These investments have resulted in substantial domestic job creation, increased direct and indirect business expansion, and significant federal, state and local tax revenues. Within our company alone, we have increased our employee base from 248 employees at year-end 2004 to approximately 1,500 employees today, an increase of over 600%.

Our ability to make over $6.5 billion of capital investments and create thousands of job opportunities during this period was primarily due to our ability to generate a reliable cash flow from the sale of our natural gas production and to gain access to additional funds borrowed under our bank revolving credit facility. The ability to generate a reliable stream of cash flow was due in large part to our use of OTC derivatives to "lock in" natural gas prices. Southwestern uses these derivatives as a risk management tool for our natural gas, a commodity that we produce, own, possess and market – we do not use derivatives for speculative purposes.[1]

The impact on Southwestern and other independent energy producers if they are required to clear or post cash margin for their hedging transactions.

Southwestern regularly hedges its natural gas price exposure by entering into OTC swap transactions with multiple counterparties with S&P credit ratings ranging from BBB+ to AA. Southwestern has typically hedged 60-80% of its expected natural gas production volumes for the following year. Southwestern does not post collateral with any swap counterparty -- for a very good reason: natural gas swaps ***lower*** Southwestern's business risk and makes it a much more stable company. Like all commodity producers, Southwestern is naturally "long" the commodity, and hence, naturally subjected to the risk of falling commodity prices. Southwestern's swap counterparties understand that Southwestern is reducing its business risks

[1] Attached to this testimony as Appendix 1 is a more detailed description of the types of OTC hedging instruments Southwestern utilizes to manage its natural gas price risk.

when transacting OTC swaps and, therefore, the credit risk to the swap dealer is greatly diminished thereby eliminating the need for Southwestern to post collateral.

The imposition of mandatory clearing and mandatory margining of our hedges would cause a significant drain on working capital at a time when capital is highly constrained and credit is in short supply. There will be a liquidity drain on those companies that have taken a conservative business approach by choosing to prudently hedge their economic risks. Mandatory margining will have the unintended consequence of actually increasing financial risks as companies choose not to hedge due to working capital constraints.

In addition, increasing hedging costs by forcing all standardized derivative trades onto a clearinghouse will result in fewer market participants, more price volatility, and less price discovery. Because of the increased costs, fewer market participants will be able to hedge or the ones that can hedge, will hedge a lower volume. With fewer transactions and fewer participants in the marketplace, there will be more price volatility and less price discovery. By driving out the bona fide hedgers, the market share of speculators will increase, which does not create a healthy functioning market. A healthy market requires a balance between bona fide hedgers and speculators.

Finally, if independent energy producers are forced to post cash collateral for natural gas hedging activities, they will be unable to fully invest in their business, the exploration and production of natural gas. The additional cost from posting cash collateral would be substantial and necessarily require that independent energy producers reduce their capital investments, resulting in a dramatic reduction in drilling activity, fewer jobs and a significant decrease in domestic natural gas production. After analyzing the potential costs of posting cash collateral, Southwestern determined that during 2009, without hedging, Southwestern would have drilled 240 fewer wells in its Fayetteville Shale Project resulting in the loss of 1,500 jobs and a total economic impact to the state of Arkansas of $1.6 billion. (Appendix 2) In addition, fewer wells drilled in the United States means less domestic gas is produced, and less gas produced unfortunately means higher prices for consumers. There is a real world effect to a mandatory clearing requirement for all standardized OTC derivatives.

Southwestern's recommendation for the treatment of bona fide hedging transactions.

Southwestern believes a solution to these problems would be to provide an exemption from the clearing and margining requirements for bona fide hedging transactions, where at least one party involved is a company that produces, owns and sells (or purchases and consumes) the commodity and the transaction is directly related to managing commodity pricing risks inherent to that company's operating activities. We believe these transactions are easily distinguishable from those that are purely speculative, which appears to be the primary focus of the proposed derivatives legislation. The purpose of a clearinghouse is to require participants with true "open" commodity price risk exposure (i.e. speculators) to post capital against such risk. A company that produces, owns and markets the commodity that is the subject of the derivative contract is inherently "long" in commodity price exposure, and when that company enters into a bona fide hedging transaction it "closes" that commodity price risk position, thereby making it more stable, not less. Adding a clearing requirement to hedging transactions would add no additional value to market stability.

Southwestern's support of market transparency and reporting.

While Southwestern already reports its hedging activities on an aggregated basis in its financial reports to the SEC, we support legislative proposals to further increase market transparency and reporting. We believe that reform of the OTC derivatives markets should increase transparency and oversight to provide confidence to both market participants and consumers in the fairness of these markets. Southwestern supports requirements for its hedging transactions to be reported on an aggregated and confidential basis to all appropriate regulatory agencies, including the SEC and the CFTC.

Concluding Remarks.

In conclusion, a clearing requirement for OTC derivatives, when applied appropriately, can play an important role in mitigating operational and counterparty risk for large segments of the OTC derivatives markets. However, we believe the broad application of a clearing requirement for all OTC derivatives will hurt many American companies, particularly in the energy sector, by effectively taking away the most powerful tool for managing price-related risk.

It is our hope that the concerns we have raised are addressed so that any proposed legislation does not significantly impair our ability to use derivatives to prudently hedge the risks we face in our day-to-day operations or to ensure our continued access to the credit sources we rely upon to grow our business. Ultimately, what matters most is that American companies continue to be allowed to cost-effectively manage risks in a manner that enhances market stability and contributes to both the overall health of the economy and our country's goal of achieving energy independence.

Madam Chairwoman and members of the Committee, this concludes my testimony. I would be happy to answer any questions you may have.

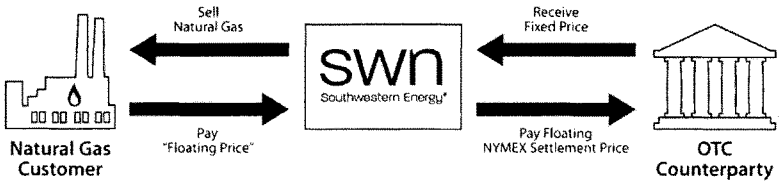
APPENDIX 1

Sample Derivative Instruments For
Hedging Natural Gas Price Risk

Southwestern hedges its natural gas price risk using OTC NYMEX gas swaps and costless collars. Both of these hedging instruments are simple and result in no initial net investment payment, thus preserving our cash flows for drilling and producing natural gas.

An OTC NYMEX swap hedge consists of a bilateral financial agreement between Southwestern and an OTC counterparty, in which Southwestern agrees to receive a fixed price for a specified volume of natural gas over a specified period of time. In return, Southwestern agrees to pay the OTC counterparty a floating price, based on a NYMEX Henry Hub monthly futures contract settlement price, for the same specified volume of natural gas over the same specified period of time. The bilateral agreement does not call for the physical exchange of natural gas; it is purely financial in nature. Upon monthly settlement, if the fixed price agreed upon in the original agreement is higher than the monthly settlement price of the NYMEX Henry Hub monthly futures contract, the OTC counterparty pays Southwestern the monetary amount of the difference in price multiplied by the specified volume. The reverse transaction takes place if the fixed price is lower than the monthly settlement price of the NYMEX futures contract. **Figure 1** below illustrates an example of an OTC NYMEX swap hedge transaction.

Figure 1

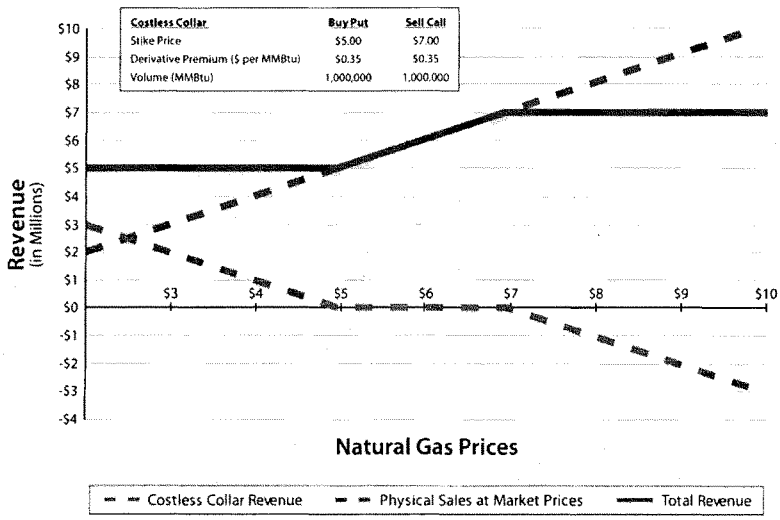


It is important to note that the financial settlement of the OTC hedge occurs at approximately the same time as the physical sale of the gas, thus eliminating a timing shortfall/surplus of cash for Southwestern. The hedge not only offsets the price risk but it also matches the timing of the cash flows so as to avoid funding risk for Southwestern.

Southwestern also hedges its natural gas price risk with another OTC hedge instrument widely used in the industry, the costless collar. The objective of using costless collars is to create a range of prices that Southwestern is willing to receive for its natural gas production. Costless collars use OTC derivatives, puts and calls, to create a floor price and ceiling price for a specified volume of gas over a specified period of time. Southwestern agrees to buy a put (the right to sell) at a specific strike price and, incorporated in the same transaction, also agrees to sell a call (the right to buy) at a higher specified strike price. Both the put and the call transactions

represent the same volume of natural gas for the same specified period of time. The put and call premiums (the prices for the derivatives) are the same, thus offsetting exactly for no initial net investment, hence the appropriate title for the instrument, the "costless" collar. Like the swap discussed above, the OTC counterparty takes the other side in the transaction. **Figure 2** below represents the revenue that would be generated by using a costless collar. The combination of physical sales at market prices and the costless collar revenue creates a range of possible revenues acceptable to Southwestern. This range of revenues creates stability that enables Southwestern to better budget its capital investments and develop its assets.

Figure 2



Southwestern's OTC counterparties have recognized the quality of the Company's producing assets and understand the concept of "right-way" risk, enabling Southwestern to hedge without having to post cash collateral. By hedging our natural gas production, Southwestern is guaranteed a future price and revenue stream. If actual prices end up being higher than our hedged price, Southwestern will owe money on the financial OTC hedge but will be actually selling the physical natural gas at higher prices enabling us to fulfill our contractual obligation on the financial OTC hedge. The reverse is also true, if prices are lower than the hedged price, the cash flow generated from the financial OTC hedge offsets the lower revenue from selling the physical natural gas at lower prices. The financial OTC hedge creates an extremely effective "offset" to Southwestern's actual physical sale of natural gas. It is Southwestern's contention and the contention of our OTC counterparties that "right-way" risk, along with our overall financial strength, afford us the ability to hedge without the need for posting cash collateral.

APPENDIX 2

The Real Cost of Mandatory Clearing

swn Southwestern Energy

What would be the impact on Southwestern's operations in the Fayetteville Shale had the Company been prevented from hedging 48% of its estimated 2009 production?

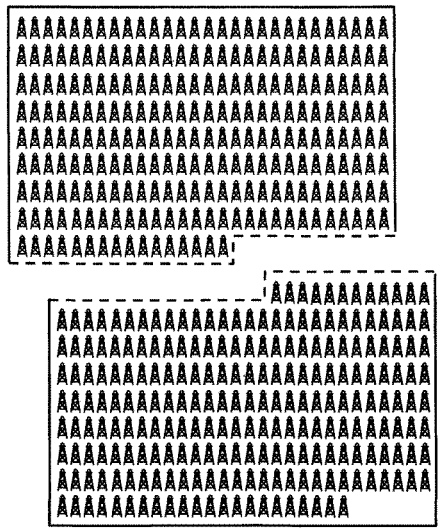
No hedges in place due to cash margin requirements.

↓

$700 million less cash available for investing.

↓

Elimination of 240 Fayetteville shale wells from our program.



2009 Program = 432 operated wells

The Real Cost of Mandatory Clearing

SWN Southwestern Energy

Economic Impact

Direct Impact	$ 1.2 billion
Indirect Impact	$ 401 million
State Tax Revenue Impact	$ 80 million
Total Impact	**<$ 1.6 billion>**

Employment Impact

Oil and Gas Related Job Impact	1,000
Indirect / Induced Job Losses *	500
Total Impact	**<1,500>**

* Based on economic and employment multipliers published in the March 2008 study entitled "Projecting the Economic Impact of the Fayetteville shale Play for 2008-2012" by the Sam Walton College of Business Center for Business and Economic Research at the University of Arkansas.

Testimony of the Honorable Glenn English, CEO
National Rural Electric Cooperatives Association

Before the
United States Senate
Committee on Agriculture

November 18, 2009

It is an honor to appear before the Senate Agriculture Committee again, and I thank you for this opportunity to share rural electric co-ops' perspective on the issue of derivatives regulation.

As most of you know, the National Rural Electric Cooperative Association (NRECA) is the not-for-profit, national service organization representing nearly 930 not-for-profit, member-owned, rural electric cooperative systems, which serve 42 million customers in 47 states. I should also note that for the states represented by the Senators on this committee alone, NRECA has 21.6 million members and 494 electric co-ops. I know that this committee cares deeply about the fate of rural America, and before discussing derivatives, I want to thank you for your strong support of the idea that someone's standard of living should not be dictated by his or her zip code.

NRECA estimates that cooperatives own and maintain 2.5 million miles or 42 percent of the nation's electric distribution lines covering three-quarters of the nation's landmass. Cooperatives serve approximately 18 million businesses, homes, farms, schools and other establishments in 2,500 of the nation's 3,141 counties. Cooperatives still average just seven customers per mile of electrical distribution line, by far the lowest density in the industry. These low population densities, the challenge of traversing vast, remote stretches of often rugged topography, and the increasing volatility in the electric marketplace pose a daily challenge to our mission: to provide a stable, reliable supply of affordable power to our members—including your constituents. That challenge is critical when you consider that the average household income in the service territories of most of our member co-ops lags the national average income by over 14%.

Madam Chairman, the issue of derivatives and how they should be regulated is something with which I have a bit of personal history going back twenty years when I was a Member of Congress on the House Agriculture Committee. Accordingly, I am grateful for your leadership in pursuing the reforms necessary to increase transparency and prevent manipulation in this marketplace. From the viewpoint of the rural electric cooperatives, the proposals to regulate the $600 trillion over-the-counter (OTC) derivatives market can be boiled down to a single, simple concern: affordability.

NRECA's electric cooperative members, primarily generation and transmission members need predictability in the purchase price for their inputs if they are to provide stable, affordable prices to their customers. Rural electric cooperatives use derivatives to keep costs down by reducing the risks associated with both volatile energy prices and financial transaction costs. It is important to understand that electric co-ops are engaged in activities that are pure hedging, or risk management. Our consumers expect us, on their behalf, to protect them against volatility

in the energy markets that can jeopardize small businesses and adversely impact the family budget. The families and small businesses we serve do not have a professional energy manager. Electric co-ops perform that role for them and should be able to do so in an affordable way. We DO NOT use derivatives for other purposes.

Most of our hedges are bilateral trades on the OTC market. Many of these trades are made through a risk management provider called the Alliance for Cooperative Energy Services Power Marketing or ACES Power Marketing, which was founded a decade ago by many of the electric co-ops that still own this business today. If a derivatives counterparty does not pay up, there will be severe consequences for our members, so we are extremely careful about who we trade with and for how much, which is why ACES Power Marketing makes sure that the counterparty taking the other side of a hedge is financially strong and secure.

Though most of our trading involves natural gas, derivatives, specifically interest rate and currency swaps, are an important asset/liability management tool for cooperative lenders as well. Half of the electric cooperatives' finance needs are met by private cooperative lenders, including the National Rural Utilities Cooperative Finance Corporation (CFC), which uses derivatives to manage currency and interest rate risk, and thereby affords our electric cooperative borrowers more loan options. Again, these products are NOT used for investment but for risk management.

Even though the financial stakes are serious for us, rural electric co-ops are not large participants in the derivatives markets. In a market estimated to be $600 trillion dollars, our members represent a tiny fraction of the market and are simply looking for an affordable way to hedge. While our small size makes us insignificant to the larger market, it does mean that legislative changes which dramatically increase the cost of hedging or prevent us from hedging all-together will impose a real burden.

I want to remind you that we are NOT looking to hedge in an unregulated market. NRECA DOES want derivatives markets to be transparent and free of manipulation. The problem is that requiring all derivatives contracts to clear is just not affordable for most co-ops. That is because the margin we would have to provide would make hedging untenable for many of our members – we would have to come up with hundreds-of-millions of dollars in cash that we just do not have on hand.

In general, co-ops are capital constrained due to their non-profit status and other capital demands, such as building new generation and transmission infrastructure to meet load growth, installing equipment to comply with clean air standards, and maintaining fuel supply inventories. As member-owned cooperatives, we cannot go to the equity markets for additional resources. Maintaining 42% of the nation's electrical distribution lines requires considerable and continuous investment. A cash margin requirement associated with clearing our trades could compromise our ability to meet that infrastructure need.

Clearing also presents a significant potential predictability issue. In case of a catastrophic event, the marketplace could change dramatically in a very short timeframe. If a catastrophic event triggered market concern over fuel supplies, ratings could shift and the prices for contracts could swing dramatically, triggering a sizable margin call for a reason unrelated to the original

trade. A co-op in that position would not have the cash reserves to cover the margin call, leaving only one, unattractive option –to borrow a large sum at unaffordable rates.

Rural electric cooperatives do trade on exchange (and thus have some trades cleared) when we can. Electric cooperatives customarily have a couple thousand trades at any given time on NYMEX, but due to the working margin requirements associated with clearing and the highly specialized nature of others, most of our trades are made on the OTC market. We would like to be able to trade our standardized contracts on an exchange or go through a clearinghouse, but many of our members just cannot afford it.

With affordability in mind, NRECA has closely examined the legislative proposals produced by the Department of the Treasury, the House Committee on Financial Services, the House Committee on Agriculture, and the Senate Committee on Banking Chairman Christopher Dodd (D-CT). With regard to the requirements that OTC derivative contracts clear, and that there be capital and margin requirements for derivatives contracts, there is recognition in the Treasury, House Financial Services, and House Agriculture proposals that trades made by hedgers should be treated differently. As requested by the Chairman, I have limited my remarks on these proposal to the specific issue of clearing and margin requirements, and I would gladly discuss other issues on request.

The Treasury proposal includes both a clearing requirement for standardized trades and separate capital and margin requirements for trades that are not cleared. Exceptions to these requirements are provided, but our co-ops would have difficulty meeting these requirements because the hedge exemption in the definition of major swap participant, which is key to the clearing and capital and margin requirement exemptions, is subject to being "an effective hedge under generally accepted accounting principles (GAAP)." This requirement is problematic because, for starters, the outcome of "GAAP hedge effectiveness" is often unknown at the inception of a derivative hedge when a co-op would have to decide whether or not it would fit in the hedge exemption. Meanwhile, as most of our trades are for natural gas, and are largely standardized, it's unlikely we would meet the clearing exemption standard that, "no derivatives clearing organization registered under the Act will accept the swap for clearing." NRECA has recommended changes to the Treasury proposal that would improve upon this hedge exemption (see Appendix).

In both the House Committee on Financial Services and the House Committee on Agriculture proposals, the definition of major swap participant is, like in the Treasury proposal, a critical test for determining an exemption to the clearing requirement, as well as additional capital and margin requirements. Neither bill utilizes the problematic GAAP standard for hedging, but both pieces of legislation specifically recognize that those, like NRECA, who are using swaps for legitimate hedging activities do not qualify as major swap participants. Importantly, not only would these bills allow co-ops to continue to hedge on the OTC market, but they would also permit us to trade with counterparties who may be major swap participants – this is critical to the continued existence of liquid and functioning OTC markets for us to trade in.

Finally, Senate Banking Committee Chairman Dodd recently introduced a discussion draft proposal that included new regulations for derivatives. Unfortunately, this draft, unlike the other proposals, does not specifically exclude hedgers from its major swap participant definition. Moreover, even if it did include a workable hedge exclusion from that definition we

are troubled that, as we saw in the Treasury proposal, GAAP standards are once again problematically used to define hedging, while this draft's clearing exemption provides no certainty to our members because it requires the CFTC to first issue an order or rule granting deeming it "necessary or appropriate in the public interest" to exempt the swap transaction from clearing. Also adding to the uncertainty, the CFTC may grant a clearing exemption when one counterparty is not a swap dealer or major swap participant only if such party also does not meet the eligibility requirements of any dealers clearing organization for swaps. We simply must have more certainty for our members' legitimate hedge transactions.

Madam Chairman, we are looking for a legitimate, transparent, predictable, and affordable device with which to hedge. I know there are many ideas under consideration, but regardless of what specific solution is arrived at, I know that you and your committee are working hard to ensure these markets function effectively. The rural electric co-ops just hope that at the end of the day, there is a way for the little guy to affordably manage risk.

Thank you.

STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

SENATE COMMITTEE ON AGRICULTURE

November 18, 2009

Good morning Chairman Lincoln, Ranking Member Chambliss and members of the Committee. Thank you for inviting me to testify today regarding the regulation of over-the-counter derivatives. I also will provide this Committee with an update on our joint efforts with the Securities and Exchange Commission (SEC) to tailor our regulations in the best interest of the American public. I am pleased to testify on behalf of the Commodity Futures Trading Commission (CFTC).

Since I last testified before this Committee, the gavel was passed from Senator Harkin to Chairman Lincoln. I would like to thank Senator Harkin for his leadership and congratulate Chairman Lincoln. I look forward to continuing to work with both Senators as well as the Committee and Congress on necessary reform.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public. Exhibit A of these twin failures was the collapse of AIG. Every single taxpayer in this room – both the members of this Committee and the audience – put money into a company that most Americans had never even heard of. Approximately $180 billion of our tax dollars went into AIG – that is more than $3.5 billion per each of your states.

While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in our regulatory structure.

I would like to address much-needed regulatory reform of OTC derivatives in the context of two principal goals: promoting transparency of the markets and lowering risk to the American public.

We embark upon this reform effort as the financial industry has become ever more concentrated. Given the events of the last decade, there are fewer providers of financial services today. There may be 15 to 20 large complex financial institutions that are at the center of today's global derivatives marketplace. Five to ten years from now, it is quite possible that the financial system will become even more concentrated. With fewer actors on the stage, it is especially important that we lower the risk of these participants and bring sunshine to the activities in which they are involved.

Improving Transparency

Economists have for decades recognized that transparency benefits the marketplace. After the last great financial crisis facing the nation, President Roosevelt called for transparency in the futures and securities marketplaces. It is now time to promote similar transparency in the relatively new marketplace for OTC derivatives.

Lack of regulation in these markets has created significant information deficits:

- Information deficits for market participants who cannot observe transactions as they occur and, thus, cannot benefit from the transparent price discovery function of the marketplace;
- Information deficits for the public who cannot see the aggregate scope and scale of the markets; and
- Information deficits for regulators who cannot see and police the markets.

To address information deficits in the OTC derivatives markets, the Administration has proposed – and I fully support – the following priorities:

First, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities. I believe that this is the only way that we can best address information deficits for market participants. Such transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the OTC swaps markets.

Increasing transparency – including a timely consolidated reporting system – for standardized derivatives should enable both large and small end-users to obtain better pricing on standardized and customized products. A municipality, for example, could better decide whether or not to hedge an interest rate risk based upon the reported pricing from exchanges. As customized products often are priced in relation to standardized products, I believe that mandated trading through transparent trading venues will benefit all end-users, whether trading with

standardized or customized swaps. Just as transactions involving end-users are not exempt from trading on existing stock or futures exchanges, I believe that all standard contracts should be brought to transparent trade execution facilities.

Second, all non-cleared transactions should be reported to a trade repository that makes the data available to regulators. This will complement regulators' ability to obtain transaction data on trades conducted through a transparent trading venue. U.S. regulators and foreign regulators should both have unfettered access to see all transactions, regardless of whether the physical locations of the trade repositories and clearinghouses are in the United States or elsewhere.

Third, data on OTC derivatives transactions should be aggregated and made available to the public. The CFTC currently collects and aggregates large trader position data and releases it to the public. We should apply the same transparency standards to OTC derivatives. This will promote market integrity and protect the American public.

Fourth, stringent recordkeeping and reporting requirements should be established for swap dealers and major swap participants and vigorously enforced. This should include an audit trail so that regulators can guard against fraud, manipulation and other abuses. Regulators also should have the authority to set aggregate position limits in the OTC markets.

Lowering Risk

To lower risk to the American public, the Administration proposed – and I support – four essential components of reform.

First, standard OTC transactions should be required to be cleared by robustly regulated central counterparties. By guaranteeing the performance of contracts submitted for clearing, the clearing process significantly reduces systemic risks. Through the discipline of a daily mark-to-market process, the settling of gains and losses and the imposition of independently calculated margin requirements, regulated clearinghouses ensure that the failure of one party to OTC derivatives contracts will not result in losses to its counterparties. Right now, however, trades mostly remain on the books of large complex financial institutions. These institutions engage in many other businesses, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades. To reduce systemic risk, it is critical that we move trades off of the books of large financial institutions and into well-regulated clearinghouses.

I believe that all clearable transactions should be required to be brought to a clearinghouse, regardless of what type of entity is on either side of the trade. This would remove the greatest amount of interconnectedness from the large financial institutions.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. I believe that it is most critical that transactions with financial firms – and in particular, hedge funds and other investment funds – benefit from a clearing requirement. These entities are responsible for a

substantial share of the OTC derivatives market and they are capable of meeting these requirements that have such tremendous promise for the responsible management of financial risk. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system.

Ever since President Roosevelt called for the regulation of the commodities and securities markets in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdictions. This well-established practice of having the agency that regulates an exchange or trade execution facility also regulate the clearinghouses for that market should continue as we extend regulations to cover the OTC derivatives market.

Second, swap dealers and major swap participants should have sufficient capital. Capital requirements reduce the risk that losses incurred by one particular dealer or the insolvency of one of its customers will threaten the financial stability of other institutions in the system. While many of these dealers, being financial institutions, are currently regulated for capital, I believe that we should explicitly – both in statute and by rule – require capital for their derivatives exposure. This is particularly important for nonbank dealers who are not currently regulated or subject to capital requirements.

Third, swap dealers should be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This would protect end-users of derivatives from a

dealer's failure as well as guard dealers from end-users' failures. End-users should be permitted to enter into individualized credit arrangements with the financial institutions that transact on their behalf, with the option of posting noncash collateral, to meet a clearing requirement.

Fourth, the CFTC and SEC should be able to mandate robust business conduct standards to protect market integrity and lower risk. Business conduct standards should ensure, among other things, the timely and accurate confirmation, processing, netting, documentation and valuation of all transactions, as well as protect against fraud, manipulation and other abuses.

Working with the SEC

Comprehensive regulation of OTC derivatives will require ongoing cooperation between the CFTC and the SEC. Last month, the two agencies jointly announced 20 recommendations for improvements to regulations and statute to best protect the American public. Of the recommendations, eleven relating to the CFTC require legislation. Of these eleven, three are part of the Administration's proposal on OTC derivatives, and one, which seeks the creation of a joint advisory committee on emerging regulatory issues, is currently before the House and Senate Appropriations Committees. We will provide language to this Committee and others on the remaining recommendations.

First, the Administration's proposal includes enhancements to the CFTC's oversight of clearing organizations, both for futures and OTC derivatives. These provisions clarify the Commission's ability to regulate clearinghouses, write rules and oversee the setting of margin to

protect the financial integrity of clearinghouses. The proposal also strengthens the core principles to bring them up to international standards.

Second, the Administration's proposal includes amendments to the CEA that would authorize the CFTC to require registration of any foreign board of trade that seeks to provide direct access to market participants located in the United States and, when appropriate, cooperate with foreign regulators to avoid duplicative regulation.

Third, the Administration proposal contains provisions creating a firewall between analysts and trading functions within intermediaries. This is similar to rules governing conflicts of interest at broker-dealers under existing securities laws.

The CFTC and SEC also have jointly recommended that Congress act in the following areas: first, legislation should be enacted to enhance the CFTC's enforcement authorities with respect to manipulative practices that undermine market integrity and the price formation process in the futures markets. Experience shows that certain practices are so disruptive to trading in the futures markets that they should be presumptively prohibited in statute.

Second, we have recommended expanding existing opportunities for portfolio margining, which is important to U.S. competitiveness. The agencies are now working together to recommend legislative language that would facilitate the holding of securities and futures in a single account, whether it be a securities or a futures portfolio margin account. The legislation

also would address protection of customer accounts if the broker-dealer or futures commission merchant becomes insolvent.

Third, we have recommended establishing legal certainty with respect to product listings. The CFTC and SEC are working on legislative language that would clarify their exemptive authority and would outline a review process to ensure that any jurisdictional dispute is resolved by the Commissions – not staff – against a firm timeline. Should the Commissions fail to resolve the dispute within the strict timeline, the matter would be referred to a federal court of appeals.

Fourth, we have recommended that all intermediaries that provide investment advisory services, whether regulated by the CFTC or by the SEC, should be subject to uniform fiduciary duty standards. Commodity trading advisors, commodity pool operators and introducing brokers should be subject to the same standards as broker-dealers or investment advisors when performing the same advisory functions. Robust customer protection should apply equally across the securities and futures markets.

Fifth, we have recommended that Congress consider legislation to encourage whistleblowers to come forward with relevant information to authorities in both SEC and CFTC registered markets.

Sixth, legislation should clarify that restitution should be calculated to fully compensate victims for their lost investment. This would address future uncertainty related to an appellate

court decision that measured restitution as the gain to the defendant, rather than trading losses suffered by victims.

Finally, we have recommended legislation to expand the scope of insider trading coverage under the CEA. Currently, for example, misuse of material non-public information from government agencies other than the CFTC is not punishable. The CEA should be amended to make unlawful the misappropriation and trading on the basis of material non-public information from any governmental authority. We loosely call this the Eddie Murphy rule given the role he played in the movie "Trading Places."

The CFTC will continue to work closely with the SEC and Congress to enact these significant enhancements to our regulatory oversight.

Closing

I look forward to working with the Congress and other federal regulators to apply comprehensive regulation to the OTC derivatives marketplace and to secure additional resources so that the CFTC can effectively regulate the markets. The United States thrives in a regulated market economy. This requires innovation and competition, but also regulation, to ensure that our markets are fair and orderly. We have a tough job ahead of us, but it is essential that we get it done to protect the American public.

I thank you for inviting me to testify today. I am happy to answer any questions you may have.

TESTIMONY OF
ROBERT A. JOHNSON
DIRECTOR OF ECONOMIC POLICY
THE ROOSEVELT INSTITUTE
REPRESENTING
AMERICANS FOR FINANCIAL REFORM

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
HEARING ON
REFORMING U.S. FINANCIAL MARKET REGULATION
NOVEMBER 18, 2009

Chairman Lincoln, Ranking Member Chambliss, and Members of the Committee, thank you for inviting me to testify before you today. The American people clearly sense that there is something deeply flawed in the current structure of our financial markets and the political process that has spawned them. One does not need to be a Ph.D. in finance or economics to grasp that the ship is way off course and in need of correction. Too Big to Fail is a demoralizing eyesore that even the CEO's of the largest firms agree must cease to exist.[1] Losses of wealth, lost employment and economic activity and bailouts totaling trillions of dollars around the world are strong evidence of the failed structures of financial markets in their current form. The financial sector's calamity has spilled over and done great harm to the lives of many Americans and people throughout the world.

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[1] No More Too Big to Fail. By Jamie Dimon, Washington Post November 13, 2009. Online at http://www.washingtonpost.com/wp-dyn/content/article/2009/11/12/AR2009111209924.html

When they are properly designed, financial markets play a fundamental role in the resource allocation for our society. Well functioning markets are an important means to achieve our societal goals. Financial markets, when functioning correctly, serve to aggregate savings and allocate them to productive uses. Financial also serve to allocate risk to entities that bear it most comfortably. The system we had in place in recent years, and the one that is still in place as we meet today, has revealed profound flaws.

The Senate Agricultural Committee has, in its history, seen the benefits the derivatives markets can create when they are transparent, have safeguards against manipulation, and restrict excesses of speculation. These markets can provide a powerful resource allocation tool, provide a mechanism to distribute risk and at the same time need not prey upon the resources of civil society.

At the same time, the recent history of unregulated credit default swaps following the passage Commodities Futures Modernization Act that culminated in the failure and bailout of AIG illuminates the danger of potential legislation that does not adhere to basic principles of sound market structure.

Efforts to repair these market structures in light of the diagnosis of the crisis that began in 2007 should, in my view address the elements that caused the

crisis. I would suggest that study of the crisis reveals that at the core we have 4 problems[2]:

1) Excessive leverage
2) Opacity and complexity rather than transparency and simplicity
3) That ability to buy insurance without an insurable risk
4) A misalignment of incentives where the private incentive to take risk exceeds the social desire to bear risk.

Certain types of derivative instruments, their market structures and the associated regulatory structures, have contributed to all of these problems. It is time, in light of experience, for a thorough redesign of these market systems to enhance the real potential of derivative instruments and the repair the obvious flaws in structure have caused so much harm.

I must admit that I am very surprised by the intense focus on "End Users" of derivative instruments. That focus does appear to me to have substantially misdirected energy away from the essential task of financial reform before the

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[2] See "Over the Counter, Out of Sight, Economist November 12, 2009. Online at http://www.economist.com/displayStory.cfm?story_id=14843667
I draw particular attention to the comments of Edward Kane on the current subsidies imbedded in OTC derivatives.

""Even if dealers keep much of the benefit for themselves, everyone is getting derivatives more cheaply at the expense of the taxpayer," says Edward Kane, a professor of finance at Boston College."

United States Congress that centers on the role of the large financial institutions in creating that crisis. This diversion to end user obsessions is a dangerous exercise for at least two reasons[3].

First and foremost, efforts to legislate what types of institutions are exempt from the restrictions of healthy market practice runs the risk of creating loopholes large enough to fly a jet aircraft through. End user exemptions that are drawn too broadly serve to allow anyone and everyone to claim them, especially the large and too big to fail financial institutions that stand next to the public treasury. That would directly undermine the need to bring these markets out of the dark. It would enable the largest market participants to remain in the shadows where they earn extraordinary profits but put society and the public treasury in peril.

In addition, end user exemptions may inadvertently serve to spawn large speculative organizations or divisions of organizations that are given substantial advantage over financial institutions by legislation. The spawning of Enron-like

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[3] See Options Have a Future, Economist, November 12, 2009. Online at http://www.economist.com/opinion/displaystory.cfm?story_id=14845187 My thoughts are very similar to the conclusions of this editorial which states,

"The trickiest issue concerns exemptions for end-users, such as manufacturers. Allowing companies to hedge their risks is the whole point of the instrument. But if the rules favour them over financial companies, trading will tend to migrate towards them, and away from banks. AIG, once the world's biggest insurer, thought it was making "easy money" by using its strong credit rating to sell protection against credit defaults; in fact, it was digging its own grave.

These reforms may raise the price of using derivatives, but that would not necessarily be a bad thing. When fire and theft premiums rise, those who really need insurance still pay up. "

entities is the risk implicit in creating legislative that confers special advantage for certain types of market participants.

Secondly, the exemption of certain classes of financial products such as foreign exchange forwards and swaps, or any products that are traded on foreign platforms will surely serve to drive more activity offshore, perhaps to locations where the underpinning market structures are themselves unsound. This is akin to the process where manufacturing employment moves to where proper labor rights and environmental restrictions are not present. The movement of resources offshore leads to private profit at the expense of greater pollution and social harm.

Foreign exemptions will also likely divert creative energy into the creation of complex "foreign exchange" based products to qualify for that exemption and thereby avoid the scrutiny and structures that healthy market structure and regulation require. That would also undermine the need to bring these practices into the light.

There has been a great deal of testimony, here today, and before other Congressional committees, that goes to great length to justify end user exemptions. This body of testimony tries to illuminate the consequences for end users of requiring them to trade upon exchanges or submit their transactions to

clearinghouses. While I do agree that some increase in cost will be borne by these end user institutions if the current market structures are replaced by more robust and healthy market structures, I believe the magnitudes of the costs they report they would incur are somewhat exaggerated and that they pale in comparison to the trillions of dollars of lost output and employment that this crisis has caused, even for their own firms. I agree with them that end users were not the primary cause of this crisis and that they are not deserving of any particularly punishment. Yet punishment is different than adjustment to the removal of an unhealthy subsidy. I cannot agree with many of their conclusions and descriptions of the likely consequence of the changes to our financial market structures that are necessary to prevent a crisis of this magnitude from recurring in the not too distant future.

First of all, as economists are fond of saying, there is no free lunch. Efforts to hedge market exposures by commercial users are primarily a transfer of risk, rather than a diminution of the underlying risk. An oil hedger is not reducing the volatility of oil prices, but merely transferring to another party, for a price, who will bear that oil price volatility. When market structures are weak and unsound they serve under-price that insurance and the implicit subsidy encourages the overuse of insurance. In the case of the OTC derivatives market that is largely run by the handful of TBTF banks, the insurance offered to end users is under priced because the risk is in part borne by the public/taxpayers

who underpin the safety net that backstops those banks. Removing that back room subsidy and the excessive use it inspires, something called moral hazard, would lead to an increase in the cost of providing risk transfer insurance and would have the impact that many end users describe in their testimony. Removing a subsidy would lead to a diminished profits, and less use of insurance and some more costs for the consumers of those services. Where I differ from many of the end users claims is that I believe that this would be a good thing for the nation and the economy as a whole. Removing subsidies to the buyers of insurance does not make the world a more dangerous place. It merely redistributes who bears that risk away from those who had heretofore provided the subsidy.

The American private sector, be they end users of financial products or financial institutions, does not need to clamor for subsidies from the taxpayer in order to thrive. That type of rent seeking behavior is demoralizing for society and unproductive. It weakens the economy in the long run. It preys upon the general interest and at the same time government willingness to honor those efforts to extract subsidies from the public fisc actually weaken the companies who would do much better in the long term if they were to be refused state welfare and forced to focus on new product development and innovations in the marketplace that would create a more profitable productive future.

Reforming the financial structure of the U.S marketplace is essential to restore confidence in the U.S. capital markets and to stabilize the U.S. dollar as the reserve currency of the world. Transparent market structures, proper capitalization, regulation and restoration of market discipline to our largest financial institutions are the essential ingredients needed to restore integrity and confidence to our marketplace. They are a public good that nourishes us all. The transition from subsidy based commerce to a proper realignment of incentives for the use of financial instruments is a painful but healthy transition. If done properly it will also greatly diminish the possibility that future financial bailouts will reemerge and crowd out the use of our public finances for much needed infrastructure, education spending and healthcare that make our society stronger.

I will submit the balance of my remarks for the record.

The Importance of OTC Derivatives Reform

OTC derivatives reforms are, in my view, the centerpiece of the financial reforms that are necessary to address the flaws of our financial system that were revealed by the crisis that began in 2007-8. Derivative instruments are pervasive and their regulation is intimately intertwined with the health of the financial system. The experience of AIG and their exposure to unregulated credit

default swaps (CDS) is the most glaring example of the reckless nature of an unregulated derivatives market. CDS buyers in the so-called shadow banking system felt that their purchased protection was a substitute for bank shareholder capital. Yet the writers of the CDS protection, in the case of AIG, did not appear to, and were not required to, set aside adequate capital. As a result, the taxpayer's capital was extracted to support the counterparties of AIG such as Goldman Sachs and a number of foreign banks who did not pay into any kind of guarantee pool for insurance. This web of connections was considered too dangerous to let fail and it was an example of the hazards of unregulated OTC derivative market breakdown. The AIG debacle is an important structural episode to learn from, but it is not the only one. Derivatives regulation is not a subject to be treated in isolation. OTC derivative reform impacts all of our financial system's vital interconnections. It is the very fabric of our financial system.

I believe that the most important dimension of all of the needed financial reforms is the precise intersection between Too Big to Fail financial institutions and OTC unregulated derivatives. This intersection is the equivalent of the San Andreas Fault of our financial system. We are in a new era where the size of the capital markets, and their derivative instruments are a dominant dimension of the intermediation of credit. Derivatives transparency is essential to the safety and soundness of our financial system as a whole and it is essential to the protection

of the public treasury. Without OTC derivatives reform enhanced resolution powers for dealing with insolvent institutions could well be rendered impotent and future crises in the credit allocation system will likely be longer and deeper than is necessary.

End User Arguments and The Social Impact

In recent letters and testimony some end users have emphasized the impact on jobs and the competitiveness of their firms if they were to lose access to customized derivatives and be forced to rely solely upon standardized contracts.

The impacts of changes in market architecture are important for the Committee to understand when it considers new legislation. At the same time it is important to understand the context of these claims and the overall impact on employment of any changes you enact. We have a financial architecture in place governing derivatives that has failed profoundly. The bailout costs, lost output around the world, and breathtaking rise in unemployment are the result of that financial failure. When an end user talks about how changing practices in the derivatives market will end up costing jobs at his firm one has to place this in that context. If a dysfunctional derivatives market has led to over use of derivatives throughout the system and has made them too cheap to use because

provision for the integrity of the system was not built into the costs, then it is imperative to improve that system architecture and force the end use to incur the costs they rightfully represent that they will experience. The resulting system, fortified and more transparent and well regulated, would reduce the likelihood, and magnitude, of a recurrence of a financial calamity. Not only would society be better off with lower unemployment, but the end user in question would likely experience less disruption to demand for his/her product and not be forced to lay off as many employees in the event of a disruption. Reform would increase jobs and stability of employment in his/her own sector in the larger scheme of things. We have, in recent years, had a financial system where the private incentive to take risks exceeds the social value of those risky actions. We have subsidized financial speculation indirectly and underpriced insurance by not setting up proper market structures, particularly in the aftermath of the Commodities Futures Modernization Act. When a subsidy is diminished, those who benefit from it are forced to adjust, profits are curtailed, and employment diminished at the margin. Those effects are important to understand, but they do not constitute a reason to refrain from repairing a broken system. Society and the end users are each likely to be better off when the system's integrity is repaired. The kind of disruptions to commerce we have recently experienced are enormous, dreadful and unnecessary.

The challenge for the Committee will be to create legislation that preserves as much scope for deriving value from derivative instruments for end users without making the definition of end user so broad that it allows large scale financial institutions to effectively continue their unregulated OTC practices and at the same time assures that end users do not themselves, through loopholes, contribute to a weakening of the integrity of the financial system Derivatives coupled with Too Big to Fail firms have shown that they are very dangerous. . I applaud your efforts to undertake this formidable challenge.

DERIVATIVES ARE A LARGE PRESENCE IN CAPITAL MARKETS

OTC derivatives markets are vitally important because of their size, and because of where positions are concentrated in relation to other vital functions of our economy/society. Derivative contracts have become an enormous proportion of the total notional credit exposure in U.S. and world financial markets. According to the International Swaps and Derivatives Association (ISDA) survey, the outstanding notional amount of derivatives is over 454 trillion dollars at mid year 2009. The Bank for International Settlements puts the number at nearly $800 trillion worldwide. Using ISDA data, that is over 30 times U.S. GDP.

According to the flow of funds data from the Federal Reserve, total credit market debt outstanding is just under $53 trillion dollars. Derivatives are not a minor dimension of U.S. or international capital markets. They occupy a dominant position.

The location of derivatives exposures is also important. According to the U.S. Office of the Comptroller of the Currency report for June 30th, 2009, U.S bank holding companies with $13 trillion in assets hold a notional $291 trillion in total derivatives. Most importantly, the institutions that were at the core of the crisis and controversial bailouts in the fall of 2008 are at the same time the dominant institutions in the OTC derivatives market. In fact, according to the Office of the Comptroller of the Currency, the Top 5 institutions in terms of derivatives exposure, Citigroup, J.P. Morgan/Chase, Bank of America, Morgan Stanley and Goldman Sachs hold over 95 percent of derivatives exposure of the top 25 Bank Holding Companies, of which 90 percent is OTC. This is why I call this the financial equivalent of the San Andreas Fault. Our Too Big to Fail Institutions, the same ones that have relied on the support of the public treasury in the crisis, are the dominant market participants in the OTC derivatives market. As a result, U.S. taxpayers have a very strong and direct interest in how the derivatives markets are structured and regulated.

DERIVATIVES REFORM IS A KEY ELEMENT OF TOO BIG TO FAIL POLICY

Derivative securities are a sizeable proportion of the risk on the balance sheets of our largest bank holding companies. That is a reasonably recent development occurring over the last 25 years. In the era of depression reforms, bank lending and securities holdings were the dominant asset on bank balance sheets. The interface between government and our largest financial institutions, starting with the founding of Central Banks, and continuing through the creation of deposit insurance, was predicated on a traditional banking model. As deregulation and consolidation proceeded side by side over time, the chain of credit intermediation became much more complex. Capital markets grew in importance relative to bank intermediation of credit. The explosive growth of derivatives markets transformed credit allocation and rendered many of the traditional policies designed to protect the essential functions of credit markets obsolete. The vision that informed those policies remained largely based on the structure of the traditional banking model. The OTC derivatives market, which is so deeply interwoven into the operations of our largest scale financial institutions, can no longer be ignored. I believe, that the so-called Too Big to Fail policy is intimately intertwined with derivatives regulation policy. Along with international harmonization of resolution laws, derivatives regulation is the essence of the capacity to resolve failing institutions on a timely and least-cost basis to protect our taxpayers. It would not be too strong to say that the architecture of derivatives regulation and market structure is the heart of Too Big to Fail policy.

Absent a drastic simplification of derivative exposures and a transparent and comprehensive improvement in the monitoring of those positions when imbedded in large firms, complex derivatives render these behemoth institutions Too Difficult to Resolve (TDTR). I say that because, the policies of resolving troubled financial institutions, so- called enhanced resolution powers, cannot be invoked unless government authorities have the capacity to assess and understand the entanglements of derivatives exposures throughout the financial sector and the economy at large. Resolution powers themselves can be quite useful and should be passed into law as a part of the financial reform you are considering. The ability to undertake "prompt corrective action" vis a vis bank holding companies and financial services holding companies, as the FDIC can now do vis a vis failing banks, would diminish the probabilities of a cascading bankruptcy or other disruptive panic. Yet opaque, complex entangled derivatives exposures would serve to deter the authorities from invoking those powers and taking over a failing institution for fear of setting off a system wide calamity of magnitudes that policy officials can dread but not understand or estimate. Complex entanglements through derivatives exposures discourage government officials who are the risk managers on behalf of the citizens of our nation from invoking and using those powers. The spider web of complex opaque derivatives renders enhanced resolution powers impotent. It is in this respect that complex and opaque derivatives exposures at large financial

institutions contributed mightily to a policy of induced forbearance, as we witnessed in the first quarter of 2009. That experience, as we have seen, was very demoralizing to our citizens who have put their faith in philosophies that emphasize the use of markets as a mechanism for achieving social goals. The inhibitions that authorities experience in applying market discipline to large financial institutions and their managements tend to undermine belief in the use of markets.

What makes induced forbearance of TDTR institutions even more troubling is that their potential creditors would understand that they will not have their debts restructured when government officials are deterred by complex derivative exposures from taking a TDTR institution into receivership and restructuring the entity. This would create the perverse impact of reducing the risk premium on the unsecured debt of these institutions, lowering their funding costs, and giving them incentive to take more risk. It would also create a competitive advantage for TDTR firms that encourages an increase in their market share relative to those firms who had to pay more for funding because their creditors would fear that their bonds could be restructured in the event of solvency problems. TDTR financial institutions are enabled to get larger and larger by wrapping themselves in a spider web of complex derivatives and thereby inducing authorities to make ever-larger scale gambles on forbearance. Forbearance is a two-sided coin. Firms can continue to lose money rather than

return to health. This is not a tolerable state of affairs for taxpayers who are held hostage by the fear of resolving complex intertwined institutions.

OPAQUE DERIVATIVES MARKETS BREED FEAR WHEN MARKETS ARE SHOCKED

The damage done by complex and entangled derivative exposures embedded in financial institutions is not limited to its impact on resolution policies and bailouts. Perhaps even more damaging is their impact at times when the financial system has been adversely shocked, such as was the case when the real estate market bubble burst around the turn of 2006/2007. At such times, when concern about counterparty default risk are heightened, the presence of complex and opaque positions, the value of which are very difficult, if not impossible to ascertain, may engender fear and lead to a freezing up of credit markets. When no one can prove that a financial institution is solvent, even if it is, then the credit allocation process seizes up, and both deepens and prolongs the downturn and the deleveraging spiral that ensues.

Complex OTC derivatives are private transactions. When compared to standardized transactions that are traded on exchanges, they are opaque.[4] OTC transactions are subject to prolonged periods of mispricing. When the prices finally adjust in response to adverse news, capital can evaporate. OTC transactions are capable of imbedding leverage that is difficult to detect. A system that is very large in transaction volume that fosters leverage, opacity and suspect valuation is one that contributes to the fragility and fears that produce heightened perceptions of counterparty default risk and lead to deep and prolonged dysfunction of the credit allocation process. I believe that repair of the regulatory structure of housing finance is necessary but not sufficient to fortify our financial system. OTC derivatives regulation must also be addressed and profoundly redesigned to meet this challenge.

DERIVATIVES MARKETS AND PRICING DO NOT NEED TO BE OPAQUE

I have referred repeatedly to the notion of opaqueness and derivative instruments. They are not one and the same. It is possible to have derivative exposures that are quite easy to evaluate and value. What has been problematic is that many unregulated and OTC custom products are difficult to value. They are private by their very nature, yet when traded by large institutions they butt up

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[4] See the Appendix I for information on these differences between OTC, clearing and exchange trading and the role of the Commodities Futures Modernization Act in enabling OTC trading and opacity.

against the public guarantees. It is in this respect that the legislation you are considering is absolutely vital to the functioning of the U.S. financial markets.

Opaqueness relates to valuation. OTC derivatives that are complex combinations are often priced by resorting to mathematical computer models. These models do not reflect actual market prices, but rather, they reflect valuations of securities "as if" perfect markets existed to value them. [5] When actual market conditions, which often include asymmetric information about the underlying quality of a given asset, are present, these "mark to model" prices are for the most part meaningless indications of the worth of that underlying asset. This leads to periods of large and discontinuous changes in the value at which assets are carried on balance sheets and to drastic changes in the measures of available capital. Unfortunately, these discontinuities in pricing are rarely confined to just one institution in the system. Many firms are likely to have the same problem at the same time and then the system as a whole begins to experience capital shortage and forced asset sales in a synchronized manner.

The danger to the economic system that contains a large array of complex customized derivatives is that in large quantities they can create very misleading impressions of the value of an instrument, or more powerfully, a portfolio of

[5] "Perfect markets" is a phrase that refers to assumptions in economic theory. Perfect markets are those that meet all of the assumptions that have been explored by mathematical scholars such as Gerard Debreu and Kenneth Arrow. Suffice to say that the conditions of perfection are so strict that they virtually never are experienced in practice.

positions, or most frighteningly the value (solvency) of entire institutions, that do not get subjected the discipline of real pricing. This arouses suspicion that cannot be dispelled and makes the adequacy of capital unknowable. Regulators themselves can receive reports but cannot discern the true state of health of financial institutions under such circumstances. We saw that in the last two years. It is not just about having a systemic regulator. It is also vital to give that regulator meaningful information that corresponds to the real risk contained within the financial system. GIGO or Garbage In Garbage Out the computers scientists often say. One must be able to accurately diagnose and interpret what is in the report for meaningful regulation and supervision of financial institutions to take place and protect our society.

The remedy for this in the realm of derivatives is to price these instruments based upon real values of actual trades on an open exchange. Exchange traded derivative instruments have real prices based upon actual transactions and the exchange imposes real margin (capital set aside) upon participants to insure their ability to honor their contract obligations. In addition, the exchange itself must put capital up to honor the contracts and the members of the exchange have incentive to make sure that contracts are valued at real market prices. The publication of price data that is based upon trading on the exchange augments the transparency of the process by giving market participants guidance regarding the real value of a particular instrument. Thus pricing and margin are frequently

adjusted and reported in light of ever changing market conditions. Absent that, our regulators, and for that matter, many executives at large institutions, will be like sailors at sea in a fog without a chart of the waters they traverse.

The means to overcome this opacity is to direct nearly all of the volume of derivatives trading onto an exchange. Having said that, a very important dimension of this process, from a system integrity point of view, is that legislators and regulators make sure that the exchange members post sufficiently large capital as members of the exchange so that the problems of Too Big to Fail do not merely migrate from the balance sheets of financial institutions to the balance sheet of the exchange. Proper capitalization is easier to estimate when real prices exist, but the political will to insist on proper levels of capital must also be present.[6]

EXCHANGE TRADING IS PREFERRED TO CLEARING

Many market participants advocate central clearing institutions rather than exchanges as the means to improve market structures. It is clear that such mechanisms are a marked improvement over current OTC practices of carrying trades on the books at mark to model prices. Clearinghouses do require margin

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[6] See Insight: The Clearing House Rules by Gillan Tett, Financial Times, November 5, 2009. http://www.ft.com/cms/s/0/5874e922-ca1d-11de-a5b5-00144feabdc0.html

and mark to market. That is an important step. Yet when compared to exchange-based trading, there is less data published to enhance transparency by clearinghouses than by an exchange. Pricing and transaction costs are more transparent in the case of exchange trading

THE COSTS AND BENEFITS TO END USERS OF DERIVATIVES REFORM

The discussion of OTC derivatives and the accompanying letters from many so called "end users" [7] of derivatives suggest that moving the trading of derivatives from OTC custom contracts to exchanges would entail great cost to their business efforts. I have read the positions presented by several of the end users and I see no reason to doubt the qualitative impacts on their business practices that they suggest. Yet I feel that this tells only a partial story for several reasons.

First, it is difficult to measure the quantitative effects of the loss of perfectly fit custom contracts. It is surely not the case that they must lose all risk management or hedging benefits if derivatives contracts were standardized in time and in adherence to a specific underlying instrument. In the professional practice of hedging there are many methods of imperfect hedging that

[7] I use the phrase "so called" to emphasize that a massive derivatives trading operation such as that created by ENRON would have been deemed an end user by many practitioners. In addition some very large commodity firms have very substantial speculative operations as a key element of their business strategy.

approximate the perfect hedge. The difference between the hypothetical perfect risk management tool, and the risk alleviation that which would result from combining standardized instruments is referred to as "basis risk". For instance if the only interest rate hedge were a contract that expired on December 21st for 10 year bonds but the company in question wanted to create a contract that hedged them until December 14th the hedge would be imperfect. The cost in terms of basis risk would not be the presence or absence of interest rate hedges, but rather, the 7 day time mismatch in the expiration of contracts. There would still be 7 days left on the contract that the hedger would liquidate one week before expiration of the standardized exchange contract. In practice this is likely to be a very small cost. When futures exist for many of the underlying economic variables, interest rates, foreign exchange prices, and commodities, these imperfect hedges can be easily constructed, even for complex transactions. My overall point is not that there will be no costs, but rather that it is not an "all or nothing decision" that end users face if customized OTC derivatives are unavailable. They would not be left with no risk protection if complex customized OTC derivatives were not available. It would just be less perfect fit. As one of my friends quipped recently, corporate treasurers and bankers would metaphorically have to return to wearing off the rack suits rather custom suits if complex derivatives were eliminated!

My concern, as mentioned in the introduction to this testimony, is that the exceptions created in the name of preserving latitude for customization by the end user actually act to provide a giant sized loophole for financial institutions to avoid standardization and maintain their profit margins from maintaining opaque OTC market structures at great potential risk to the overall economy. It appears to me that the task before Congress is one of reforming the derivatives market structures, making them stronger, more standardized, less opaque, and to afford the maximum degree of precision for risk managers. There is no need for unnecessary restrictions but this is a very slippery slope indeed. Imprecise language, regarding foreign transactions and transactions involving "non major market participants", appears to create very large potential exemptions that could serve to merely codify current market practice. What is of particular concern is the role that the language could in allowing our largest financial institutions to qualify for those exemptions given their proximity to the public purse. No one wants to see another bailout. I believe the harm done to society if such loopholes are allowed to become law far exceeds the benefits to end users of OTC custom derivatives. OTC custom derivatives should be a special case, with large capital provisioning to support their use and to protect systemic integrity. The vast majority of contracts should be standardized and traded on exchanges. Providing for end users should not be allowed to be a Trojan horse for perpetuating a flawed architecture that makes our financial system more fragile and dangerous.

Furthermore, I do not think that increasing end user costs associated with OTC derivatives reform are substantial and they certainly do not constitute a basis for refraining from substantial efforts to change derivatives regulation in a way that makes our derivatives markets more transparent and our financial institutions more manageable and transparent.

THE IMPACT OF OTC DERIVATIVES REFORM ON LARGE SCALE FINANCIAL INSTITUTIONS

At the core of the impact resulting from proper repair and reform of the regulatory system for OTC derivatives are adjustments in market practice that will impact financial institutions, particularly the very large financial institutions who have been at the center of the bailout and TBTF discussions. A natural consequence of improving transparency and information on pricing is that the intermediaries who dominate the market will see lower profit margins and somewhat lower volume of transactions. The negative impact on earnings of the top banks, that have made more than $15 billion in the first half of 2009 from derivative trading, is likely to be significant. Brad Hintz, a financial analyst at Sanford C, Bernstein and Co. estimates that proper derivative reforms could reduce the earnings of large institutions by 15 percent by moving to clearinghouses and even more if transactions were moved to exchanges [9]

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[9] Wall Street Stealth Lobby Defends $35 Billion Derivatives Haul.

This impact on financial institutions as a result of OTC derivatives reform is important for two reasons. First, one can be rightly concerned, to the extent that these large institutions are the same ones that are borderline, or deeply insolvent as a result of past practices and the crisis. In that case, policies that diminish their earnings will prolong the period in which credit markets are impaired and other forms of revenue, such as credit card fees and usury, are presented to consumers of credit.[10] I believe that is a risk and cost we must bear in the name of strengthening our financial system against the threat of another shock. Two wrongs do not make a right. Another crisis of this magnitude will strain society's resources and the fabric of political consent beyond what any of us want to imagine. Second, making markets more efficient at lower costs is desirable from a social point of view. Financial institutions are a means to an end, rather than an end themselves. Legislation to improve the efficiency of the market system improves the productivity of society and, if at the same time these market structures are repaired to be less vulnerable to crisis it is also of great social value. The diminution of the earnings of Wall Streets largest firms would be a sign of progress and productivity and efforts to resist the transition by Wall

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By Christine Harper, Matthew Leising and Shannon Harrington Bloomberg News, August 31, 2009. http://www.bloomberg.com/apps/news?pid=20601109&sid=agFM_w6e2i00

[10] See John Dizard, How We Will Pay for Ongoing Bank Losses, Finanical Times, October 11, 2009. http://www.ft.com/cms/s/0/93ac45d6-b4fa-11de-8b17-00144feab49a.html

Street firms, while understandable, are harmful to society and the economy on the whole.

WALL STREET PROTECTIONISM

In 1970 the automotive industry was at the apex of the world economy. Yet for many years thereafter, as the automotive industry struggled to adjust to the new realities of global commerce, executives from the Big Three spared no effort of time, money or energy to plead with Congress to relax social policy requirements regarding fuel emission standards rather than devoting their energy and resources to R&D directed at improving their products. The result was that together, the auto industry and Congress produced a failure that is all too evident today.

Today Wall Street and the City of London sit at the apex of the economy, not unlike the automotive companies did nearly 40 years ago. It is my hope that our nation will resist "helping" Wall Street adjust in the destructive way they enabled the auto industry to avoid modernization. Wall Street spent many years in public discourse thwarting and resisting the appeals for protection from the declining manufacturing sector. Is it too much to ask them now to practice what they have preached to other sectors of the economy repeatedly? I am confident in the intelligence and vitality of the men and women who work on Wall Street

today. They are very able and do not need "Wall Street Protectionism" to survive and to thrive. Would it not be better to inspire them, particularly in light of this crisis, to adapt to a more vital market system rather than to acquiesce to their demands perpetuate a system that protects their profits at the risk of exposing society to a danger to the integrity of our financial system that has caused so much hardship in the present and recent past?

Resisting the demands of Wall Street firms on OTC derivatives reform is easy to agree to, in principle, and difficult to accomplish in practice. Market structures with integrity are a public good. As University of Chicago Professor Luigi Zingales has written recently, "most lobbying is pro-business, in the sense that it promotes interests of existing business, not pro market, in the sense of fostering truly free and open competition." [11][12]

THE CHOICE: REFORM OR ENDORSEMENT OF A MAN MADE FAULTLINE

Wall Street's leaders cannot control their urge to seek protection despite the fact that it is demeaning to their reputations. Yet the members of this

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[11] Capitalism After the Crisis, National Affairs, Issue 1 Fall 2009. http://www.nationalaffairs.com/publications/detail/capitalism-after-the-crisis

[12] See the illuminating collection of writings on the history of struggles between business interests and the politics of American society contained in Thomas Ferguson's extraordinary book entitled Golden Rule, University of Chicago Press, 1995.

Committee and your counterparts in the Senate are responsible for resisting their demands for the good of society. I do believe that this is no minor matter. The financial security and strength of our nation is in the balance. Confidence in the U.S. dollar as the world's foremost reserve currency depends upon the integrity of our financial system. As I stated at the outset, I believe that the intersection between the OTC derivatives market and the large financial institutions is the financial equivalent of the San Andreas fault. Yet there is one difference. The San Andreas fault is a natural occurrence that we must all cope with to mitigate the consequences of an earthquake. It is beyond our power as people to eliminate. The current state of OTC derivatives regulation and its relation to the guarantees of large financial institutions are a man made fault that is the product of past human errors financial legislation and regulation. It has been revealed by catastrophic events to have devastating consequences. It has produced an avoidable earthquake. That earthquake and its consequences need not be repeated. One can only imagine the consequences for the reputation of those public officials who would choose to act to codify into law this fault line and expose our society to a repetition of the financial crisis that has devastated the world in recent months.

To avoid reform would be harmful enough. We know the fault lines of past human error regarding the regulation of OTC derivatives continue to threaten us. But to affirm the status quo with new legislation that codifies these

structural flaws and deems them to be healthy would be far worse. This is not about just leaving a few crumbs on the table for big financial institutions and asking the rest of us to pay a little more. This is about the representative government of our society choosing to affirm a dangerous financial structure that could explosively harm us all again just after we experienced a severe and unnecessary crisis that resulted from these very failures of design. It would be both dangerous and demoralizing for America and the world if our legislators choose to take that path forward in deference to the parochial desires of a few firms in the financial sector or end users who are clamoring to preserve a subsidy their risk mitigation methods.

APPENDIX I: HISTORY OF ACTIONS CREATING LOOPHOLES LEADING TO UNREGULATED DERIVATIVES.

Exchange Trading vs. Clearing Before CFMA

Under the law governing the regulation of derivatives (the Commodity Exchange Act of 1936 ("CEA") as amended) prior to the passage of the Commodity Futures Modernization Act of 2000, all standardized futures contracts were to be traded on a fully regulated exchange and the futures contracts traded thereon and the exchanges themselves had to be preapproved by the CFTC. Failure to trade a standardized futures contract on a regulated exchange was prior to the passage of the CFMA of 2000 a felony UNLESS the instrument traded was exempt from exchange trading pursuant to a fully transparent CFTC rulemaking process with notice to the public and comment allowed. Such an exemption can only be issued by the CFTC after notice and comment if that agency finds that the off exchange trade is in the public interest and cannot be subject to fraud or manipulation.

The exchange trading requirement includes: full transparency of trading prices and volumes; reporting to the CFTC of large trader positions; anti-fraud and anti-manipulation authority; self regulation by the exchange; and the regulation by the CFTC and exchange self regulation of intermediaries, e.g., futures brokerage houses (called "Future Commission Merchants"), brokers, traders, etc. FCM's are subject to full regulation. Brokers and traders are licensed. Brokers and traders cannot act "recklessly" and if authorized to conduct trades on behalf of customers, brokers owe a fiduciary relationship to the customer. FCM's are strictly liable for the actions of their brokers and traders. By requiring clearing, the CEA assured that there would be capital adequacy supporting trades, i.e., the posting of margin at trade initiation, and collecting margin on a twice a day mark to market process.

The CFMA created two major loopholes to the CEA's exchange trading requirement.

CFMA/SWAPS. Section 2 (g) created the swaps exemption. Under the CFMA, a swaps transaction could be traded off exchange if both counterparties were eligible contract participants (e.g., meet minimal net worth requirements) and if the swap was "subject to individual negotiation." The latter "negotiation" requirement has been honored in the breach. The overwhelming number of swaps transactions are done pursuant to standardized, boilerplate, and copyrighted ISDA (International Swaps Derivatives Association) Master Agreements and accompanying documentation.

CFMA/ Enron Loophole. At the behest of Enron, any energy or metals futures product was exempt from the exchange trading requirement at the request of the party wishing to trade these products. The only restriction is that the CFTC has to be notified of the trading. Otherwise, the CFTC has no regulatory oversight except that it can lodge fraud and manipulation actions against this kind of trading. However, because the trades do not need to be reported (nor are there record keeping requirements), it is very hard to bring fraud and manipulation actions.

Because of widespread abuses of the Enron loophole, Congress in May 2008, as part of the Farm Bill, gave the CFTC authority on contract-by-contract basis to reregulate Enron Loophole trading if the CFTC can demonstrate that the contract has a "significant price discovery function." The CFTC recently has begun to reregulate some of these contracts, most prominently the Henry Hub natural gas contract traded off exchange by the Intercontinental Exchange under the Enron Loophole. There have been dozens of hearings before Congress since December 2007, concerning what has now become almost conventional wisdom that the unregulated energy futures markets have contributed to excessive speculation which have unmoored the price of crude oil, gasoline, natural gas, etc. from supply demand fundamentals.

TESTIMONY OF NEIL M. SCHLOSS
VICE PRESIDENT AND TREASURER, FORD MOTOR COMPANY
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
NOVEMBER 18, 2009

Madam Chairman, Ranking Member Chambliss, and members of the Committee, Ford Motor Company appreciates the opportunity to share our views on the important role of financial derivatives and their regulation. Derivatives are integral to our business: the manufacture, sale, and financing of vehicles worldwide.

Ford Motor Company is a global automotive industry leader that manufactures or distributes automobiles across six continents. We have about 200,000 employees and about 90 plants worldwide. The company provides financial services through Ford Motor Credit Company.

The financial crisis certainly impacted our stakeholders, consumers and our company. With that said, though. we were prepared for a deterioration in economic conditions.

Ford's plan is working.

Our underlying business is growing stronger despite continued weakness in the economy. We are positioning ourselves to profitably grow as the economy recovers. Our plan is unchanged and our priorities are clear – deliver great products, a strong business, and a better world.

At Ford Motor Company, managing risk is a key part of our business in both the manufacturing and financial services segments. We use over-the-counter derivatives to help mitigate risks that are the result of natural two-way flows that are generated from being a global manufacturing and financial service business. We do not use derivatives to speculate or bet on the potential changes in the economy or financial markets – they are a risk mitigation tool only.

We are pleased that most of the draft legislation focuses on swap dealers and major swap participants, and excludes end users such as Ford and its affiliates (including securitization trusts).

We fully support legislation to strengthen over-the-counter derivatives regulations, promote transparency and facilitate federal oversight of these critical markets. Well-functioning derivatives markets are important to us.

We welcome the opportunity to present our view on the legislative reforms and the impact on end users like Ford.

BACKGROUND

As of September 30, 2009, we had about $108 billion of derivative notional outstanding, including:

- $93 billion of interest rate derivatives
- $14 billion of foreign exchange derivatives, and
- $1 billion plus of commodity derivatives.

Today, a substantial proportion of our derivatives are at Ford Credit, with about 60% of our interest rate derivatives being utilized to hedge asset-backed securitization transactions. As of September 30, 2009, Ford Credit's securitization funding totaled about $57 billion, or about 60%, of our $94 billion in managed receivables. The securitization and other funding Ford Credit uses enables it to provide financing to the vast majority of Ford's 3,000-plus dealers and over 3 million active consumer accounts in the U.S. alone.

All of these derivatives are over-the-counter customized derivatives. Only a small fraction of our derivative trading relationships require us to post margin; instead, the common practice is that we pay an upfront credit charge commensurate with the risk of the underlying transaction.

As of September 30, 2009, the market value of our derivatives has a net fair value of about positive $900 million and was a receivable to Ford and its subsidiaries – this is the amount the banks would owe us if we needed to terminate the derivatives.

I would like to give you some examples of how we use derivatives to manage risks that result from our normal course of operations, beginning with interest rate risk.

Ford Credit – Importance of Derivatives for Funding

Interest rate exposure is the biggest risk we manage using derivatives today. Interest rate risk results from differences in terms of interest rates on the loans we extend to dealers and consumers versus the rates on the funding we raise in the capital markets.

In the U.S., we offer our retail customers fixed payments at fixed interest rates. However, much of our funding is driven by investor preferences for floating rate notes and bonds.

Ford Credit's largest funding source is the asset-backed securitization market, which often uses trust structures. Most of our securitization funding involves issuing floating rate debt purchased by investors in private and public transactions. This structure requires the trust to enter into customized interest rate derivatives to eliminate differences between the floating interest rate on the debt and the fixed rate consumer loans being securitized. The interest rate risk between the securitization funding and

the underlying securitized assets must be fully hedged to protect the trust and the investors against adverse changes in interest rates.

The global credit crisis has increased our reliance on securitization funding and, therefore, has increased our need for securitization-related customized derivatives.

Apart from securitizations, we also use interest rate derivatives to manage the overall interest rate risk of Ford Credit.

Ford Credit looks to access the debt and capital markets on a global basis to access diverse investors with the ultimate aim of lowering our overall borrowing costs. We purchase derivatives to hedge the resulting currency exposure. An example of this would be our Ford Credit U.S. operations issuing Euro denominated bonds and the currency being swapped back to U.S. Dollars to fund our business here.

Auto Company -- Foreign Exchange and Commodity Derivatives

We are a capital intensive business with various manufacturing and assembly facilities around the world producing vehicles that are sold globally. Many of the product and sourcing decisions are made several years prior to the final delivery of products.

Without hedging, we would be exposing ourselves (and potentially our customers) to meaningful volatility to profits and cash flow.

For example, our F-Series trucks manufactured in Kentucky, Michigan, and Missouri are shipped to various markets across U.S., Canada, Mexico, and other countries. Currency exposure resulting from F-Series production costs being in U.S. Dollars and revenues in Canadian Dollars and Mexican Pesos is hedged using foreign currency swaps, forwards, and option contracts.

Similar exposures exist all over the world both on products and components.

We also have exposures related to our heavy use of commodities and precious metals in the manufacturing of automobiles. Price movements in these commodities can have a significant cost impact. There are two ways we hedge these exposures. First, we use over the counter derivatives to hedge those commodities that have a deep and liquid financial hedging market. Examples of these would be precious metals, aluminum and copper. For these commodities we use commodity forward and option contracts. Second, where derivative markets are not fully developed or unavailable, we also entered into longer term supply arrangements to lock in the price with a supplier. Examples of these commodities would be steel and plastics.

Our goal in hedging currencies and commodities in our auto manufacturing operations is to lock in some near term certainty for the revenues and costs of our vehicle production worldwide. Once again, we do not use derivatives for speculation.

Although we can see the merits of credit default swaps ("CDS") in facilitating risk management and facilitating access to capital, we do not buy or sell CDS derivatives ourselves.

FORD'S POSITION

As an end user of derivatives, Ford Motor Company recognizes that well-functioning derivative markets are important. We fully support legislation to strengthen the OTC derivatives regulations that would promote transparency to facilitate oversight of markets and activities of participants. Ford believes that reporting all transactions to a central repository would promote market transparency and allow for federal oversight of these important capital markets

We appreciate the fact that the general intent of most of the draft legislation is to focus on swap dealers and major swap participants, and to exclude end users such as Ford from clearing, margin, and capital requirements.

Similar to other end-user corporations and manufacturers, we are concerned that imposing clearing, margin, and capital requirements on end users would significantly increase our cash requirements and costs. We are also concerned that such requirements could provide a disincentive to hedge business risks.

Mandatory margin requirements would necessitate incremental funding and, unlike swap dealers and major swap participants, most corporations do not have expedient and low-cost access to liquidity sources such as the Federal Reserve discount window and FDIC-insured consumer deposits. In our case, raising additional capital requires lead time and is relatively more expensive for corporate end users. Additionally, given that the nature of our derivative requirements are generally driven by one-sided exposures, we are disadvantaged in being able to manage margin compared to swap dealers who generally see more trading flow and have a broader base of counterparties to allow for lower margin requirements.

Impact on Asset-Backed Funding

One of our biggest concerns related to derivative market reform is the potential disruption in the asset-backed securitization markets. As we have indicated earlier, Ford's captive finance business relies heavily on securitization markets to fund loans and leases to our U.S. dealers and consumers.

Securitization transactions use derivatives to protect investors from market risks and support triple-A ratings required to access these markets. We are concerned that mandatory clearing and margin requirements on these customized derivatives will force major structural changes on securitization transactions at a time when credit markets remain fragile. The present market practice is for one-way posting of margin for the benefit of the investors (securitization trust) only. Mandating a margin requirement on securitization trusts would result in substantial additional cost, legal and administrative

complexity for existing transactions, and would require investor and rating agency approvals on existing transactions, which could be very difficult to obtain. Going forward, these provisions could prevent Ford Credit and many others that use the securitization markets from efficiently accessing floating-rate note investors. Limiting investor demand will directly impact the amount of financing that would be made available to our dealers and customers.

At a time when many financial institutions were curtailing credit availability, Ford Credit continued to consistently support most of Ford's 3,000 plus dealers and Ford Credit's portfolio of more than 3 million retail customers during the credit crisis. It is important for us and many others that the recovery in securitization markets remains strong.

Although securitization market access and liquidity have significantly improved since the TALF launch in March 2009, the market remains fragile for many asset classes. With the TALF exit planned for March of 2010, it is our view that a mandate to rewrite securitization market conventions on margin posting could significantly damage the recovery in securitization markets that TALF has been so helpful in fostering.

In summary, we are hopeful that securitization trusts (ours and others) can qualify for an end-user exemption. After all, it is difficult to envision any securitization trust as systemically important and the nature of a securitization swap is purely for protection and hedging. In the absence of an end user exemption, we would strongly advocate that securitization derivatives be allowed an exemption similar to what is being widely proposed for foreign exchange swaps and forwards in various Senate and House legislation.

CLOSING

In summary, we appreciate recognition in Congress that end users such as Ford only use derivatives to mitigate risk. As legislation is crafted, the distinction between pure risk mitigation and speculation is important to maintain. End users represent only a fraction of the derivatives market, virtually all of our derivatives are used for risk mitigation, and the credit risk they entail is already fully priced into the transaction up front. We thank this Committee for giving derivatives market reforms the serious attention it deserves and for inviting us to share our views.

DOCUMENTS SUBMITTED FOR THE RECORD

NOVEMBER 18, 2009

Joint Association Statement on Proposed Reform of Over-The-Counter Derivatives Markets

The associations noted[1] represent the electric power and natural gas industries serving every energy consumer in the United States. We use over-the-counter (OTC) derivatives extensively to manage commodity price risk for electric power, natural gas and other fuels, as well as to contain risk related costs when financing energy infrastructure. OTC derivatives contracts help to insulate our customers from excessive price volatility and help keep energy costs paid by consumers stable and affordable. It is also important to note that the hedging transactions of our members are not the source of systemic risk to the broader economy. We also would like to note that we represent only the listed energy sector organizations and not any financial or banking institution. Our interests are focused on end-use risk management practices and well-functioning energy markets.

We appreciate the opportunity to submit this statement on the reforms being considered by the Senate Agriculture Committee to the OTC derivatives markets. These associations support the goals of well functioning markets and stability in OTC derivatives markets. When considering any increased regulation of exchange and OTC derivatives markets, we believe that there should be an appropriate balance between (1) establishing market oversight rules that provide regulators with the ability to establish a high level of transparency and protect consumers against market manipulation and systemic risk, and (2) providing end users with continued access to a broad range of market-based risk management tools.

We believe that reform to the OTC derivatives markets should increase transparency and oversight to provide confidence to market participants and consumers in the fairness of these markets. In our view, effective OTC derivatives reform should:

- Facilitate transparency of OTC derivatives and ensure the authority to the Commodity Futures Trading Commission (CFTC) to prevent manipulation of the derivatives markets.

- Provide a clear exemption for end-users that use OTC derivatives markets to hedge against commodity price risk for natural gas, wholesale electric power and other energy-related commodities. The hedging transactions of derivatives end-users do not contribute to systemic risk and, therefore, should be exempted from the definitions of swap dealer and major swap participant.

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[1] America's Natural Gas Alliance, American Exploration and Production Council, American Gas Association, American Public Power Association, American Wind Energy Association, Edison Electric Institute, Electric Power Supply Association, Independent Petroleum Association of America, Interstate Natural Gas Association of America, Large Public Power Council, and Natural Gas Supply Association, National Rural Electric Cooperative Association.

- Promote clearing of standardized derivatives between large financial dealers, where appropriate, through regulated central counterparties to reduce systemic risk and bring additional transparency through dissemination of information regarding pricing, volume and risk. However, the associations and their members are opposed to mandates for end-users that would require all or most OTC derivatives transactions to be centrally cleared or executed on exchanges. There has been no evidence presented to support the notion that clearing would bring pricing benefits that would offset the increased cost of margining for natural gas and power derivatives, in fact all indications are that the cost of margining would far exceed any potential pricing benefits from clearing.

- Promote the harmonization and clear delineation of regulatory authorities and functions among the Securities and Exchange Commission (SEC), the CFTC, the Federal Energy Regulatory Commission (FERC) and other Federal agencies to ensure similar products and transactions are governed by similar standards. Accordingly, such harmonization should also work to minimize the burden and cost of compliance with regulatory oversight. As an example, we believe that all regional transmission organization (RTO) products and services provided under a FERC-approved tariff and subject to regulatory oversight by the FERC should be exempt from duplicative regulation by the CFTC.

- Amend the proposed definition of a swap to ensure that physical transactions with enforceable delivery obligations that are financially-settled are excluded from the definition of swap. Many physical transactions are settled through a book-out, which is an agreement between two parties to a forward contract to settle their respective obligations with a cash payment, as opposed to making and taking physical delivery. Book-outs have been exempted under CFTC rules since 1993.

These joint associations, however, are concerned with certain aspects of proposals to address oversight of OTC energy markets. Most notably, we oppose mandates that all derivatives transactions be centrally cleared or executed on exchanges. Such a requirement would greatly reduce the ability of companies to find the customized derivative products they need to manage their risks because clearinghouses and exchanges require a high level of margin and collateral for the derivatives and commodities products traded. Such customization is necessary for everything from specific delivery points in electricity contracts to quantities of natural gas. Without the ability to use these customized transactions, energy suppliers would be severely constrained in types of products and the costs of those products that could be offered to consumers.

While centrally cleared exchanges strictly require cash collateral, individually-negotiated OTC contracts allow hedging entities to use alternative collateral structures such as asset liens, credit lines or no collateral below agreed upon thresholds. In some cases, because of the very high credit worthiness of a hedging entity there will be a reasonable threshold that must be reached before collateral would have to be posted. Providing such flexibility frees up scarce capital for investments in new energy infrastructure. Conversely, not allowing such collateral structures and forcing all OTC transactions to clear through exchanges would unnecessarily divert substantial capital from productive investments and drive up the price of energy commodities.

In addition, for centrally cleared products to be effective, standardization and a critical mass of market participants to facilitate a robust market are essential. For example, in the case of electricity, since its unique physical nature precludes significant storage and requires that it be consumed when generated in hundreds of physical markets, the prerequisites for standardized and centralized clearing are missing. So, electricity price risk cannot be managed through a selection of exchange-traded contracts. Rather, such derivatives often require customization in order to be effective.

Limiting access to these risk management tools by mandating the clearing of OTC transactions would jeopardize the ability of energy providers to manage risks, increase consumers costs and increase excessive consumer exposure to market volatility. The OTC derivatives markets' very purpose is to provide customized solutions that meet the individual needs of customers with flexible products as well as diversified margin and collateral requirements.

Provisions requiring clearing of transactions will only increase costs and limit market participants' ability to manage risks without creating any offsetting benefits. As a primary example, utilities purchase firm supplies in the physical delivery market at prevailing market prices, and enter into OTC derivative agreements customized to meet their specific needs, reduce their consumers' exposure to future market price fluctuations and stabilize rates.

Energy producers rely on the OTC market to provide stability to cash flow, exploration and production budgets, and employment levels to maintain adequate natural gas and oil production and minimize price volatility.

Similarly, electricity suppliers use OTC forward contracts to plan for and commit to future electric power needs when they do not own sufficient generation assets to meet the total electric demand in their distribution service territories. These suppliers employ various tools to shield customers from potential price volatility in wholesale electric markets, and the availability of OTC derivatives contracts allows them to (1) avoid higher costs from the cash margin requirements of a

clearinghouse or exchange and (2) secure true hedges of the prices of wholesale purchased power at hundreds of delivery points[2].

Simply put, electricity and natural gas providers have a legitimate need to engage in bona fide risk management in the OTC derivatives markets. The overly broad imposition of mandatory clearing requirements would impose large and untenable cost increases on businesses and consumers, and severely limit the product and service offerings companies can provide to energy consumers. In addition, we are concerned that excessively restricting what entities could participate in the OTC markets could have the unintended consequence of eliminating the very counterparties used by commodity suppliers.

Additionally, while competitive financial markets provide the best risk management tools, should speculative position limits nevertheless be mandated, we encourage Congress to allow the CFTC to set such limits in a reasonable manner that would ensure the necessary liquidity in a robust marketplace for bona fide risk management transactions. Any aggregate speculative positions should not impair bona fide risk management transactions such as those our members rely on.

We stand ready to work with this Committee to craft reforms that enhance transparency and improve overall market functions without creating unintended adverse consequences for us and the consumers we serve.

Thank you for your consideration of our views on this important topic.

[2]Additionally, in many jurisdictions with restructured retail electricity markets, regulated utilities have provider of last resort obligations, requiring them to be prepared to provide service to retail customers that have chosen an alternate supplier if those customers suddenly find themselves without service from their alternate supplier (for example, an alternate retail supplier might cease operations and return its customers to the incumbent utility). Regulated utilities will similarly use OTC products to hedge against the possibility that it will need to provide service to many of these customers, and ensure that these customers continue to be served reliably at reasonable rates.

QUESTIONS AND ANSWERS

NOVEMBER 18, 2009

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Mr. Jeff Billings
November 18, 2009

Chairman Blanche L. Lincoln

1) I would like to follow-up with a question I asked at the hearing and am hoping you can give more detail to me and will repeat it here. It's been argued that with the wider bid-ask spreads, capital charges, and other fees, that using OTC derivatives to hedge might be more convenient but it is not necessarily less expensive, even without factoring in the possibility of mandated margin costs. To that end, could you compare the costs for me of one of your most standard contracts conducted over-the-counter versus similar costs of an exchange-traded hedge, and provide me with specific estimates where possible?

The only "cost" we experience for trading OTC is any difference between the bid/ask on an Exchange vs. the bid/offer spread OTC. For the Gas Authority of Georgia this difference is very minimal. On average we see the difference between a standard OTC swap and the Nymex futures contract as $.005-$.015 range depending on market conditions. We do not pay any additional fees and if we do experience capital charges they are part of the bid/ask spread. Just yesterday I placed identical hedge orders with exactly the same price limits on the Nymex exchange at and in the OTC market for January 2010 natural gas. The orders were filled simultaneously, meaning there was literally zero additional cost for the Gas Authority to execute OTC. This is not always the case, but is a real life example that the pricing differences in the two markets are minimal.

2) It's my understanding that while a lot of end users conduct business in the over-the-counter market, they still do a lot of their business in the exchange/clearinghouse worlds. If you can break it out, what's the relative break down in percentages between on and off-exchange trading? How are those decisions made on which markets to use?

In the case of the Municipal Gas Authority of Georgia, well over 90% of our transactions are on the over-the-counter (OTC) market. APGA has no data in regard to the percentage of its member's transactions that are on and off-exchanges. Generally, public gas systems utilize OTC markets because the delivery point products tend to be cheaper and more liquid. For many market locations, using only NYMEX contracts to hedge would be considered incomplete (and probably not pass a hedge effectiveness test) since the unhedged location basis differential risk is so large. In the case of the Gas Authority of Georgia, we would only transact on an Exchange if there is a significant pricing advantage to do so, which in the last several years has been infrequent.

3) Has the recent credit crisis led folks to increase their use the regulated futures markets compared to their usage before last fall?

I am only aware of one municipal entity that increased futures usage as a result of the recent credit crisis, but I do not know the specific situation that drove their decision. In the case of the Gas Authority we have not increased our use of futures. It is important to note that the futures products are not a one-for-one replacement for existing OTC products, so it is not simple to switch. Moreover, nearly all of the major OTC counterparties used by public gas systems have weathered the financial crisis and remain a superior value when compared to futures markets. Our hedge policy requires an A+ minimum credit rating requirement for short-term hedges and AA- for hedges of 24 months and beyond. In addition, companies can decrease collateral threshold limits with counterparties seen as having increased risk. In our view, using a well structured ISDA agreement is just as effective from a credit risk standpoint as clearing, and doing so provides greater savings to our members and ultimately their customers.

4) Does your advice to your individual members include insights on price discovery for natural gas in the Southeast based on how the other members' swap transactions are conducted or do you treat each member's trading activity in isolation? Most of the hedging done for the Members of the Gas Authority is done collectively. However, most of our Members also offer hedging services for industrial end-user customers located behind their gas system and those hedges are executed separately by the Gas Authority in the OTC market.

It is the Gas Authority's job to make sure we are receiving proper price discovery for the Members' swap transactions. The Gas Authority does not currently charge any fees for the execution of swaps for Members or industrials located in our Members towns, but if those future transactions required clearing we would have to charge a fee to recover the cost of having lines of credit in place to meet collateral requirements.

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Mr. Mark Boling
November 18, 2009

Chairman Blanche L. Lincoln

1. I would like to follow-up with a question I asked at the hearing and am hoping you can give more detail to me and will repeat it here. It's been argued that with the wider bid-ask spreads, capital charges, and other fees, that using OTC derivatives to hedge might be more convenient but it is not necessarily less expensive, even without factoring in the possibility of mandated margin costs. To that end, could you compare the costs for me of one of your most standard contracts conducted over-the-counter versus similar costs of an exchange-traded hedge, and provide me with specific estimates where possible?

   Before comparing the cost of an OTC hedge and an exchange-traded hedge, I would like to first address the effect of margining as it relates to Southwestern's ability to continue conducting its business without making significant reductions in capital investments. As I stated in my testimony on November 18th, if the clearinghouse margin requirements had been in effect on June 30, 2008, Southwestern would have had to post $740 million in cash margin, a sum that would have exceeded Southwestern's total debt outstanding by the end of 2008. Such a large cash outlay that can fluctuate daily based on changes in natural gas prices would be extremely difficult or nearly impossible to plan for and fund. Sourcing the necessary funds to meet the margin requirements would require Southwestern to significantly reduce its capital investments or significantly increase its level of indebtedness, assuming that financing of this magnitude would even be available. Under these circumstances, the cost of posting cash collateral would be determined by measuring the cumulative negative impact to both Southwestern and the U. S. economy resulting from the dramatic reduction in drilling investments, the loss of jobs and the significant decrease in domestic natural gas production.

   It is also important to note that in comparing an OTC hedge with a hedge executed on an exchange, certain attributes of the hedge can determine whether it is even capable of being executed on an exchange. The most important of these attributes are size (volume of natural gas hedged) and tenor (term of the hedge). Southwestern typically hedges its natural gas price risk one to three years out and in volume amounts of 8 to 20 billion cubic feet (Bcf) per hedge. This annual volume equates to approximately 2 to 5 NYMEX futures contracts a day. Currently on the NYMEX exchange, liquidity for natural gas futures contracts (i.e. the ability to execute transactions) is significantly less than in the OTC market. Sufficient liquidity on the NYMEX exchange only goes out approximately six months and hedge transactions over one contract per day are very difficult to get filled. Given these liquidity limitations, it would not be possible for Southwestern to effectively manage its price risk if Southwestern was required to conduct its hedging transactions on an exchange.

Since the OTC hedges Southwestern enters into cannot be executed on an exchange as current conditions exist, we have prepared what we consider to be two plausible examples of shorter-term natural gas hedges that can be compared: (1) a swap executed on an exchange and cleared; and (2) a swap cleared but not executed on an exchange, both of which are compared to a natural gas swap executed in the OTC market and not cleared.[1]

Because the size and tenor of the sample hedge have been significantly reduced (so as to simulate a hedge that can be reasonably executed on an exchange), the dollar amounts in the two examples are relatively small. If size and tenor were not restricted due to lack of liquidity, the savings of OTC hedging as calculated below would be much greater. For example, Southwestern has hedged approximately 45% of its currently projected 2009 natural gas production of approximately 300 Bcf. If Southwestern produced the same annual volume of natural gas over the next three years (2010-2012) and hedged its expected gas production in the same manner as it has done in the recent past, the cost savings identified in the following examples could be in the range of $20-$40 million.

The terms and assumptions of our first example are attached hereto as Appendix 1. In this example, the bid/ask spread for a calendar 2010 NYMEX natural gas OTC swap as of December 2, 2009 is $5.035 by $5.065. In other words, the OTC counterparty is willing to "buy" the swap from Southwestern for $5.035 or "sell" the swap to Southwestern for $5.065. The extra $0.005 included in both the bid and ask price represents the "credit charge" that the OTC counterparty is charging. This credit charge amount is based on Southwestern's experience in comparing live quotes from published exchanges (i.e. NYMEX and ICE) with quotes received from Southwestern's counterparties. Since the total volume of natural gas hedged for the transaction is 3,650,000 MMBtus, the embedded "credit charge" is calculated as 3,650,000 x $0.005 = $18,250.

This example accounts for the lower liquidity available on the NYMEX exchange versus the OTC market by using a wider bid/ask spread for the exchange-traded swap. The spread in our example is $5.03 by $5.07. This wider spread makes the exchange-traded swap more expensive to Southwestern even before calculating the additional costs associated with posting margin. With respect to the cost of posting margin, we used a range of interest rates for margin interest calculations and a range of potential future natural gas prices for variation margin calculations. The resulting matrix reflects the range of cost savings to Southwestern ($38,457 to $210,276) of the sample OTC hedge versus the sample exchange-traded hedge.

In the second example, we have compared the costs of an OTC swap that is cleared and an OTC swap that is not cleared. The terms and assumptions of this example are attached hereto as Appendix 2. Similar to our first example, the bid/ask spread for the OTC swap that is not cleared is $5.035 by $5.065. For the OTC swap that is cleared, we have removed the "credit charge", thus making the bid/ask spread $5.04 by $5.06. In this example, the interest charges Southwestern would have to pay for the margining requirements more than offset the improved bid the Company would receive from the counterparty. Using the same range of interest rates for margin interest calculations and the same range of potential future natural

[1] All assumptions concerning market prices and charges used in the following examples are estimates derived by Southwestern and attempt to describe the current market and credit conditions for Southwestern only.

gas prices for variation margin calculations, the OTC swap that is not cleared would save Southwestern between $1,957 to $172,801.

It should also be noted that under current exchange conditions, Southwestern would incur incremental administrative costs for hedging using exchange-traded swaps. Southwestern estimates that these additional administrative costs would be approximately $500,000 per year.

2. Can you give me a rough idea of what share of U.S. natural gas users, such as utilities, fertilizer and plastic manufacturers and the food service sector, hedge their price risk through OTC swap transactions, and what is unique about these contracts that makes it more advantageous to conduct them through bilateral swaps rather than be traded on open markets?

Specific percentages of U.S. natural gas users that hedge their price risk through the OTC market are difficult to gather. However, based on discussions with some of our counterparties, we surmise that roughly 45-70% of U.S. natural gas users hedge price risk in the OTC market. Our best guess at a breakdown is as follows:

(1) Utilities 70-80%
(2) Large Industrials (Steel, Auto, Petrochemical, Refineries, Fertilizer, etc.) 40-50%
(3) Other Natural Gas Users 10-30%

An International Swaps and Derivatives Association (ISDA) survey released on April 23, 2009 polled the Global Fortune 500 companies on their use of derivatives. Of the 153 U.S. companies surveyed, 140 companies reported use of derivatives to hedge risk. The survey also reported that 49% of the Global Fortune 500 companies used commodity derivatives with the highest percentage usage in Utilities (83%) and Basic Materials (79%).

There are several unique characteristics of OTC hedging using bilateral agreements. OTC counterparties allow Southwestern the most flexible terms with regard to size, tenor and customization, which results in Southwestern being able to more effectively and efficiently hedge its commodity price risk. For example, as mentioned in the answer to the first question, Southwestern prefers to hedge one to three years out and at volume amounts that can only be effectively executed in the OTC market. This is because the OTC market is the only market with the liquidity necessary to support the hedging transactions that Southwestern uses to mitigate its commodity price risk.

We would also note that the wording of this question (i.e. "more advantageous to conduct them through bilateral swaps rather than be traded on open markets") seems to imply that the OTC market is not an "open market". For Southwestern, price discovery and competition, key components of an open market, are more than sufficient in the OTC market. Southwestern currently has 13 different OTC counterparties with which it can transact its hedges through bilateral agreements. Southwestern is able to gather competing bids from multiple counterparties in a timely fashion whenever the Company decides to execute a

hedge. Bids are extremely competitive and indicative of exchange futures pricing, where exchange market data is available on a timely basis.

However, the most vital aspect of OTC hedging for Southwestern is the ability to hedge its commodity price risk without having to post collateral. Southwestern's OTC counterparties have recognized the quality of the Company's producing assets and understand the concept of "right-way" risk, enabling Southwestern to hedge without having to post collateral. By hedging our natural gas production, Southwestern is guaranteed a future price and revenue stream. If actual prices end up being higher than our hedged price, Southwestern will owe money on the financial OTC hedge, but because Southwestern will be selling the physical natural gas at the higher price, Southwestern will receive the funds necessary to fulfill its contractual obligation on the financial OTC hedge. If prices are lower than the hedged price, the cash flow generated from the financial OTC hedge offsets the lower revenue from selling the physical natural gas at lower prices. The financial OTC hedge creates an extremely effective "offset" to Southwestern's actual physical sale of natural gas. It is Southwestern's contention, and the contention of our OTC counterparties, that "right-way" risk, along with our overall financial strength, afford us the ability to hedge without the need for posting collateral.

3. Does your company use "cleared only" swaps such as those cleared through the NYMEX Clearport facility or through any other DCO/clearinghouses? Did your company start using "cleared only" swaps more after the current credit crisis hit? If so, was there a reason for that?

   No, Southwestern has not cleared any of its hedges. Southwestern currently transacts its OTC hedges with 13 different counterparties with S&P credit ratings ranging from BBB+ to AA. As provided in Southwestern's Commodity Risk Management Policy, the financial condition of each counterparty and the level of financial exposure the Company has to each counterparty is reviewed periodically by Southwestern's Chief Financial Officer to determine if any counterparties should be removed from or added to the Company's approved list. Southwestern's internal audit department performs periodic reviews of the Company's hedging activities to ensure that they are consistent with the requirements and overall objectives of the Company's Commodity Risk Management Policy.

APPENDIX 1

Comparison of cost between an OTC swap and a swap traded on an exhange and cleared

Date:	December 2, 2009	**OTC bid price:**	$5.035
Price terms:	Last day NYMEX natural gas price for each monthly contract	**Exchange bid price**	$5.03
Tenor:	Calendar 2010 NYMEX Strip - Jan. 1, 2010 to Dec. 31, 2010	**Total volume:** (MMBtus)	3,650,000
Volume:	10,000 MMBtus a day or 1 contract a day	**Initial margin per contract:**	$4,146

Total Cost Savings

Interest Rates	Natural Gas Prices				
	$5.00 or under	$5.50	$6.00	$6.50	$7.00
2.50%	$38,457	$41,157	$65,525	$89,894	$114,263
3.00%	$42,498	$45,738	$74,980	$104,223	$133,465
3.50%	$46,539	$50,319	$84,436	$118,552	$152,668
4.00%	$50,581	$54,901	$93,891	$132,881	$171,871
4.50%	$54,622	$59,482	$103,346	$147,209	$191,073
5.00%	$58,663	$64,063	$112,801	$161,538	$210,276

APPENDIX 2

Comparison of cost between an OTC swap not cleared and a OTC swap cleared

Date:	December 2, 2009	**OTC bid price:**	$5.035
Price terms:	Last day NYMEX natural gas price for each monthly contract	**Exchange bid price**	$5.04
Tenor:	Calendar 2010 NYMEX Strip - Jan. 1, 2010 to Dec. 31, 2010	**Total volume:** (MMBtus)	3,650,000
Volume:	10,000 MMBtus a day or 1 contract a day	**Initial margin per contract:**	$4,146

Total Cost Savings

Interest Rates	Natural Gas Prices				
	$5.00 or under	$5.50	$6.00	$6.50	$7.00
2.50%	$1,957	$4,169	$28,538	$52,907	$77,276
3.00%	$5,998	$8,653	$37,896	$67,138	$96,381
3.50%	$10,039	$13,137	$47,253	$81,369	$115,486
4.00%	$14,081	$17,621	$56,611	$95,601	$134,591
4.50%	$18,122	$22,105	$65,968	$109,832	$153,696
5.00%	$22,163	$26,589	$75,326	$124,064	$172,801

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Cong. Glenn English
November 18, 2009

Chairman Blanche L. Lincoln

1) I would like to follow-up with a question I asked at the hearing and am hoping you can give more detail to me and will repeat it here. It's been argued that with the wider bid-ask spreads, capital charges, and other fees, that using OTC derivatives to hedge might be more convenient but it is not necessarily less expensive, even without factoring in the possibility of mandated margin costs. To that end, could you compare the costs for me of one of your most standard contracts conducted over-the-counter versus similar costs of an exchange-traded hedge, and provide me with specific estimates where possible?

By being able to hedge fuel price risk over-the-counter utilizing bilateral credit approval provided by the counterparty, a cooperative does not have to allocate significant cash or credit to its hedging program. If the cooperative did have to use its cash and credit to hedge fuel price risk, the overall cost to borrow for the cooperative would likely go up making it more expensive to conduct its overall business. In addition, the resources required to manage the volatility of cash management would likely increase. If these were to occur, a cooperative may not be able to afford the overall cost of fuel hedging and decide to no longer hedge fuel price risk. With the increased volatility in fuel prices as a result of not hedging, the volatility in fuel prices will demand more of the cooperatives attention which could put other areas of the cooperative's business at risk. If the cooperative were not able to hedge fuel price volatility, the volatility would be passed on to the customer making their operation riskier and possibly make the customer a credit risk to the cooperative.

The following is an example of a transaction recently executed by a cooperative. The example compares the costs associated with executing a transaction over-the-counter vs. what the costs would have been had the cooperative executed the transaction through NYMEX. A cooperative purchased 160,000 MMbtu of natural gas per month for calendar 2011, the equivalent of 16 NYMEX contracts per month or 192 total NYMEX contracts. The calendar 2011 hedge was purchased over-the-counter at a price of $6.37. At that time, the same product could have been purchased through the NYMEX at $6.365, a difference of $9,600. The OTC transaction had no fees while the NYMEX transaction would have had fees of $1,720. That made the OTC transaction $7,880 more

expensive to execute. However, had the cooperative executed through the NYMEX, the cooperative would have had to post initial margin of $736,000 on the following day. If prices dropped 10%, the cooperative would have to post an additional $1.25 million to NYMEX. With interest rates at 4%, that is equal to $29,440 per year for the initial margin and $50,000 per year for the maintenance margin. With the OTC transaction, no initial margin is required and the credit extended by the counterparty is more than sufficient to cover the potential market move of this transaction. Prior to expiration of the transaction, the NYMEX position would need to be sold resulting in an additional $1,720 in NYMEX fees. The OTC position settles financial against the NYMEX settle price at no additional cost.

Summary of potential costs:
NYMEX = $1,720 + $1,720 + $29,440 + $50,000 = $82,880
OTC = $9,600

By being able to execute this transaction through the over-the-counter markets, the cooperative is able to reduce its fuel price risk for 2011 and focus on running its day to day business operations.

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Chairman Gary Gensler
November 18, 2009

Chairman Blanche L. Lincoln

1. Regarding the current "standardization" of the swaps market, it is estimated that up to 80% of outstanding swaps are already "standardized." It is also estimated that the size of the OTC swaps market is approximately $592 trillion in notional value per year, and federal regulators don't see the trading or clearing of these markets. I think that if we know what we are doing now, it will be easier to figure out what we could be doing after reform. Please explain what is meant by "already standardized" and in doing so, could you explain what you believe the correct definition of "standardization" should be in regards to OTC contracts? Basically, I want to know how easy it would be to standardize what is going on currently in the swaps market. Also, can you break down for me the major parts of the OTC swaps market that are more standardized than others, and, if you can, share an estimate of the size, in notional dollars, of each major swap category?

   A common term in the OTC industry is "plain vanilla" for those swaps that are essentially standardized. The markets for these swaps are large and liquid. The notional amounts or dates may vary, but most terms are standardized and agreed to in master contracts. In considering whether a swap is standardized objective criteria could include: the volume of transactions in the contract; the similarity of the terms in the contract to terms in standardized contracts; whether any differences in terms from a standardized contract are of economic significance; and the extent to which any of the terms in the contract, including price, are disseminated to third parties. Finally, while it may sound a bit circular, swaps that are cleared could be presumed to be standardized. On this final point, it should be noted that the NYMEX Clearport already clears swaps, particularly energy swaps, in the US and LCH.Clearnet already clears many swaps, particularly those between dealers, in the UK and Europe. Of course, going forward it may require rule makings by the CFTC and the SEC to provide precise definitions of standardization.

   The CFTC is unable to determine the relative standardization of the OTC derivatives market's respective segments.

   With regard to the aggregated size of each major swap category, please refer to the table obtained from the Bank for International Settlements' (BIS) Quarterly Review for December 2009. It is important to note that this table does not separate standardized from non-standardized derivatives and represents an aggregation of the two.

Table 4: Global OTC derivatives market, end-June 2009[1]

In billions of US dollars

	Forwards and swaps				Options			
	Total	with reporting dealers	with other financial institutions	with non-financial customers	Total	with reporting dealers	with other financial institutions	with non-financial customers
	Notional amounts outstanding							
All contracts[2]	**529,893**	**179,430**	**298,471**	**49,777**	**74,729**	**35,088**	**31,040**	**6,580**
Foreign exchange	**38,179**	**14,033**	**17,370**	**6,777**	**10,596**	**4,858**	**4,071**	**1,666**
US dollar	32,521	12,671	14,953	4,898	8,216	3,961	2,985	1,269
Euro	16,794	5,723	7,484	3,587	3,859	1,753	1,297	809
Japanese yen	7,141	3,248	2,826	1,067	4,297	2,106	1,662	529
Pound sterling	5,600	1,780	2,573	1,246	613	233	255	125
Other	14,303	4,644	6,904	2,755	4,206	1,663	1,943	600
Up to one year	23,752	9,270	9,871	4,611	6,551	3,190	2,293	1,068
Over one year	14,427	4,763	7,499	2,165	4,045	1,669	1,779	597
Memo: Exchange-traded[3]	*136*	.	.		*104*	.	.	
Interest rate	**388,684**	**124,323**	**229,108**	**35,253**	**48,513**	**23,827**	**20,961**	**3,726**
US dollar	136,993	45,569	79,202	12,222	17,174	7,590	8,123	1,460
Euro	136,441	41,261	85,662	9,518	24,204	12,607	9,859	1,739
Japanese yen	54,271	18,404	28,508	7,359	3,181	1,990	1,069	121
Pound sterling	30,285	8,174	18,919	3,192	2,306	927	1,177	202
Other	30,694	10,915	16,816	2,964	1,649	712	733	203
Up to one year	150,630	58,058	78,782	13,790	8,513	4,578	3,141	794
Over one year	238,054	66,265	150,326	21,463	40,001	19,249	17,820	2,931
Memo: Exchange-traded[3]	*18,612*	.	.		*38,920*	.	.	
Equity	**1,709**	**447**	**979**	**283**	**4,910**	**2,209**	**2,298**	**403**
Memo: Exchange-traded[3]	*743*	.	.	.	*4,734*	.	.	.
Commodities	**1,950**	...	...	...	**1,779**	...	...	...
Credit default swaps	**36,046**	**19,184**	**15,347**	**1,516**	...	...	...	...
Unallocated	**63,325**	**21,443**	**35,669**	**5,949**	**8,930**	**4,193**	**3,709**	**786**

2. As we move on legislation, I want to be sensitive to what clearinghouses are doing now and what they could do, especially as it pertains to swaps. What's the current state of clearing swaps by CFTC registered DCOs: who is clearing, what swaps are they clearing, and how are they clearing? Also, to the extent we have information on swaps centrally cleared by foreign clearing houses, we would like to know that information as well.

   Currently, six registered derivatives clearing organizations ("DCOs") clear OTC derivatives.

   1. *The Clearing Corporation clears OTC Treasury contracts.*
   2. *Chicago Mercantile Exchange clears ethanol and energy contracts.*
   3. *ICE Clear US, Inc. clears cocoa, coffee and sugar contracts.*
   4. *International Derivatives Clearinghouse, LLC ("IDCH") clears interest rate swaps.*
   5. *LCH.Clearnet Ltd. ("LCH") clears interest rate swaps, forward freight agreements, and currency and currency index swaps.*
   6. *Natural Gas Exchange (NGX") clears natural gas and electricity contracts.*

Among these, the products with the most significant volume are the rates and repos at LCH and the energy products at CME.

In addition to the clearing by DCOs, ICE Trust and ICE Clear Europe clear credit default swaps ("CDS"). ICE Trust is a New York State chartered limited purpose trust company and a member of the Federal Reserve System. ICE Clear Europe is a Recognised Clearing House in the United Kingdom and has an application pending to be a DCO.

3. ICE Futures allows the use of "synthetics" (that is, options pricing) in extraordinary circumstances to price cotton when futures is limit up or down. Cotton merchants have complained that index funds participation in these markets has skewed cotton pricing. Do you think that ICE Futures Clearing rules effectively work to represent the price of cotton in limit market situations? Also, it is my understanding that the CFTC is working on an investigation of the cotton market. Could you update me on the status of that report?

   ICE Clearing has amended its rules to provide that the same price limit apply to both cotton futures and cotton option contracts. As a result, cotton option prices can no longer increase or decrease while cotton futures prices are restrained by price limits. Before price limits were placed on option contracts, option prices could rise higher or fall further than the futures contract's price if the futures contract had reached the daily price limit. In such a case, the price discovery function would move from the locked futures market to the option market.

   The CFTC Staff Report on Cotton Futures and Option Market Activity During the Week of March 3, 2008, was released on January 5, 2010.

4. Some exchanges are choosing to implement speculative position limits on certain energy contracts before a final rule has been issued by the CFTC on SPDC contracts and before regulatory reform has passed or been implemented. What's your analysis of the exchanges' actions in this regard?

   The Commission issued final regulations regarding SPDC contracts traded on exempt commercial markets (ECM) in March 2009. 74 Fed. Reg. 12177 (March 23, 2009). The passage of those regulations, however, has been the impetus for the adoption of position limits for the first ECM-SPDC contract – the Henry Financial LD1 fixed price natural gas contract traded on the Intercontinental Exchange (ICE) – and three other financially-settled natural gas contract traded on the New York Mercantile Exchange (NYMEX). Consistent with the recently-adopted ECM-SPDC regulations, ICE adopted spot month limits for its Henry Financial contract that are the same as those applicable to the contract to which the Henry Financial contract cash settles – the NYMEX physically-delivered Henry Hub natural gas contract. NYMEX has adopted similar spot month position limits for its three natural gas contracts that cash settle off of its physically-delivered natural gas contract. Spot month position limits for such contracts, whether

traded on an ECM or a DCM, can reduce the possibility of those contracts being used for manipulative or price distorting purposes. Unlimited positions in contracts that cash-settle off of other contracts, may be used by traders to manipulate the price of reference contracts.

Senator Kent Conrad

1) I think the Administration has laid out a thoughtful proposal on how to address the regulatory gaps in the derivatives market. However, I've heard from several end users that if they are forced to come up with additional capital to meet clearing costs, they will have to pass those costs on to consumers or stop using derivative instruments to manage business risks. How do you think we should address their concerns?

I believe that these concerns can be met. Swap dealers must be required to post and collect margin for individual transactions. Margin requirements reduce the risk that either counterparty to a trade will fail to perform its obligations under the contract. This protects end-users of derivatives from a dealer's failure and also guards dealers from end-users' failures.

To address the specific issue that you have raised, end-users could be permitted to enter into individualized credit arrangements with the financial institutions that transact on their behalf, and have the option of posting noncash collateral, in order to meet a clearing requirement.

2) What do you think we should do with respect to position limits? Should we leave them the same, or should we take action to tighten them up? Specifically, how should we handle limits on energy and metal commodities?

When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of market participants with a diversity of views. At the core of our obligations is promoting market integrity, which the agency has historically interpreted to include ensuring markets do not become too concentrated. Position limits help to protect the markets both in times of clear skies and when there is a storm on the horizon. In 1981, the Commission said that "the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited." I believe this is still true today. On January 14, 2010 the Commission voted to propose position limits on four major energy commodities: (1)Henry Hub natural gas, (2) light sweet crude oil prices (aka, West Texas Intermediate or WTI), (3) New York Harbor No. 2 heating oil, and (4) New York Harbor gasoline blendstock. This proposal is now out for public comment. The Commission is planning a public hearing in the near future to take testimony on the desirability of position limits in metals markets.

3) The exemption from speculative position limits by "bona fide" hedgers is an area that needs review. What do you think we should do with respect to the hedge exemption?

The Commission published a "Concept Release on Whether to Eliminate the Bona Fide Hedge Exemption for Certain Swap Dealers and Create a New Limited Risk Management Exemption from Speculative Position Limits." 74 Fed. Reg. 12282 (March 24, 2009). The concept release considered whether to

eliminate the "bona fide" hedge transaction exemption for swap dealers and replace it with a conditional limited risk management exemption.

If the Commission were to no longer recognize swap dealer positions as non-enumerated "bona fide" hedging transactions, then the Commission may establish a limitation on such swap dealer positions. The Commodity Exchange Act directs that the Commission shall not limit positions which are shown to be "bona fide" hedging transactions, as the Commission defines such terms. 7 USC §6a(c). Commission regulation 1.3(z) defines "bona fide" hedging transactions. 17 CFR 1.3(z).

The Commission's "bona fide" hedging transaction definition permits persons to enter into futures positions that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and such positions are established and liquidated in an orderly manner consistent with sound commercial practice. The definition lists certain enumerated hedging transactions (generally, current or anticipated cash positions).

The definition also provides flexibility for non-enumerated transactions to be recognized as "bona fide" upon specific application and approval under regulation 1.47. 17 CFR 1.47. These non-enumerated transactions include exemptions for "risk reducing" and "risk shifting" strategies in financial futures, granted in response to the 1986 report on CFTC reauthorization of the Senate Committee on Agriculture, Nutrition and Forestry.[1] *Beginning in 1991, the Commission extended the non-enumerated transaction exemptions by recognizing positions of swap dealers taken to offset price risks resulting from swap transactions as "bona fide" hedging transactions.*

4) In the 2008 Farm Bill, Congress included language known as the "Zelener fix" to clarify the jurisdiction of the Commodity Futures Trading Commission (CFTC) over off-exchange, rolling spot retail contracts designed to allow parties to speculate on commodity price movements. However, this jurisdiction was limited to FOREX trades, leaving other commodity classes vulnerable. Do you see a need to expand the Zelener fix to other commodity classes?

Yes. The Commission's enforcement staff has identified Zelener-type problems arising in commodities other than foreign currency. Accordingly, I support the expansion of the "Zelener-fix" to other commodity classes. As you know, the language in both the Administration and the House-passed version of financial reform legislation accomplishes such an expansion.

Senator Debbie Stabenow

[1] Senate Committee on Agriculture, Nutrition and Forestry, Futures Trading Act of 1986, S. Rep. No. 291, 99th Cong., 2d Sess. As 21-22 (1986).

1) One of the lessons that the financial crisis has taught us is the need for transparency--not only transparency in how asset prices are set but also transparency in the positions held by all market participants. It seems that keeping records of all trades and keeping these records in a single location is the best way to ensure that regulators have a complete picture of the market. In your testimony, you state that you favor rules for markets which required that all transactions be reported to a single trade repository. What is your definition of a trade repository and who do you envision regulating this entity?

I believe that regulators must have access to information on all over-the-counter trades to properly assess risk posed by trading in these markets.

All non-cleared transactions should be reported to a trade repository that makes the data available to regulators.

Under both the Administration and the House-passed versions of financial reform legislation, trade repositories would be subject to regulation by the CFTC or the SEC depending upon whether swaps or security-based swaps are involved. And, in the event a trade repository is not established, non-cleared trades would be reported directly to the appropriate agency. Regardless of whether a single repository or alternative approach is followed, it is very important that regulators have unfettered access to data on all swap transactions.

Europe appears to be moving in a similar direction with respect to all-trades transparency. As we move forward on this issue, we should ensure that U.S. regulators and foreign regulators have coordinated repository records.

Inter-agency jurisdictional boundaries and international borders should not be permitted to act as barriers to effective oversight of this type of trading activity.

2) A cap-and-trade system for greenhouse gases would create a new market the value of which could be hundreds of billions of dollars each year. In fact, carbon trading is currently being considered at a scale that some believe would create the largest new derivatives market in the world. We have a tremendous opportunity to design a transparent, efficient carbon market that builds on the best practices for market regulation.

   a) Given that the overwhelming majority of carbon related instruments are traded in the over-the-counter markets in the mandatory compliance markets in Europe, is it your assessment that such trading patterns will occur here in the US once mandatory compliance begins?

   The evolution of any carbon trading market flowing from mandatory compliance legislation in the U.S. will depend greatly on the details of that legislation as well as the outcome of congressional debate on financial reform legislation. The Commission looks forward to working with the Committee and the Congress to address the regulation of relevant markets.

b) Should carbon market regulation be divided across agencies such as the EPA, CFTC, SEC, and USDA, or do you think there should be a single "carbon regulator" or board of some kind? How will this work in terms of harmonization with Europe and potential other carbon markets?

The CFTC is well-equipped to oversee exchange trading of the cash and derivative instruments for carbon markets. However, the establishment of the caps and issuance of offsets would need to be done by an agency whose expertise is in the environment and pollution like the EPA.

c) Regarding international harmonization, what potential disturbances could there be in the carbon markets and true price discovery and transparency if nations allow carbon or border adjustments to be made on certain goods and services?

As long as any such adjustments are transparent and fully disclosed, markets can serve as well-functioning price discovery venues.

Senator Amy Klobuchar

1. Is there a class of OTC derivatives that you believe poses a greater risk than other OTC derivatives?

The risk of various classes of OTC derivatives varies depending on market circumstances at any given time. The risks for all classes need to be mitigated by appropriate regulatory requirements such as recordkeeping, reporting, clearing, capital, and margin.

2. Many companies use OTC derivatives to hedge away risk, and some of the proposals on the table would require these companies to post margin on these OTC derivatives. We have also heard repeatedly that posting margin will require these companies to divert a significant portion of their cash flow, which could mean less cash for other purposes, such as investing in research and development. What are the pros and cons of this issue from your viewpoint?

Appropriate margin requirements would decrease overall systemic risks. The concerns of end users in this regard can be addressed in two ways. First, individualized credit arrangements between end users and their clearing members should be permitted which would allow clearing members to take into account non-cash assets of the end-user when financing margin. Second, increased transparency and clearing will likely have the effect of significantly reducing bid/ask spreads thereby reducing end-users' overall costs.

3. In your testimony, you state that "certain practices are so disruptive to trading in the futures market that they should be presumptively prohibited in statute." What are these problematic practices?

   The Commission supports efforts to ban certain disruptive practices such as trading that 1) violates bids and offers; 2) is of the character of marking the close with the intent of influencing the settlement price; 3) trading known as spoofing, that is, bidding or offering with the intent to cancel the bid or offer before execution; and 4) uneconomic trading that has no economic purpose but for the effect on price.

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Mr. Neil M. Schloss
November 18, 2009

Questions from Madam Chairman Blanche Lincoln

Q1) I would like to follow-up with a question I asked at the hearing and am hoping you can give more detail to me and will repeat it here. It's been argued that with the wider bid-ask spreads, capital charges, and other fees, that using OTC derivatives to hedge might be more convenient but it is not necessarily less expensive, even without factoring in the possibility of mandated margin costs. To that end, could you compare the costs for me of one of your most standard contracts conducted over-the-counter versus similar costs of an exchange-traded hedge, and provide me with specific estimates where possible?

Admittedly, Ford is not in the best position to comment on exchange traded derivatives as all of our derivatives are presently customized and over-the-counter (OTC). However, our assessment is that if derivatives are standardized and moved to an exchange, the bid-ask spreads would be nominal and consistent with OTC derivatives.

Bid-Ask Spreads
We presently pay OTC bid-ask spreads of less than 0.01% of notional on a typical foreign exchange and commodity derivative and about 0.01% to 0.02% of notional on interest rate swaps.

Credit Charges
Prior to the global credit crisis in 2008, credit charges on our typical interest rate swaps ranged between 0.01% and 0.05% of derivative notional. These charges have now increased by multiples but are still far less than the cost of funding that would be required to post margin. Credit charges incurred on the highly customized derivatives held by our securitization trusts are minimal reflecting the trusts' high credit quality (normally AAA-rated).

Q2) In your written testimony, you indicated that Ford is currently holding about $108 billion in notional value of swaps. Who are your primary counterparties?

Our derivative counterparties are generally global banks that are rated single-A or better and who provide us credit such as Barclays Bank Plc., BNP Paribas, Citibank, Deutsche Bank AG, HSBC Holdings Plc., JP Morgan Chase, Morgan Stanley Bank, and Royal Bank of Scotland. We establish and adhere to exposure limits for all counterparties to minimize risk and provide counterparty diversification. None of our derivatives counterparties are hedge funds or non-bank financial institutions.

As an end user of derivatives, Ford would benefit from legislation that would strengthen derivative markets and our bank counterparties, who we believe would be classified as swap dealers or major swap participants.

Q3) It's been reported in the press that active trading in naked credit default swaps on Ford corporate bonds in 2008 helped to drive up Ford's debt costs, contributing significantly to the $14.6 billion loss that your company recorded for 2008. Wouldn't it serve Ford's interest to have the bulk of CDS contracts traded on regulated exchanges, so you could have a better handle on what is going on in that market? Wouldn't that have been better for your company?

Ford and Ford Credit's CDS spreads increased significantly in the latter part of 2008 and were substantially higher than spreads on our corporate bonds. Although we did not issue any new bonds in the second half of 2008, higher CDS spreads increased the cost of our credit line renewals and derivative trades executed during that period. The overall cost increase however was immaterial compared to the $14.6 billion loss reported in 2008.

As we indicated in our testimony, we do not buy or sell CDS but do advocate well-functioning CDS markets. Our investors buy CDS to hedge credit risk when providing us with liquidity. While we fully support legislation that would promote transparency and facilitate federal oversight, we would be concerned about regulations that would significantly increase the cost and restrict trading of these derivatives, thereby negatively impacting liquidity in the credit markets.

Q4) Many end users seem to see potentially higher bid-ask spreads or additional fees they may pay for over-the-counter transactions as an acceptable alternative to up front margin requirements of an exchange or clearinghouse, even if it turns out to be more expensive. If there is less systemic risk associated with these transactions, save for added transparency, why should we risk our system by not mandating clearing?

Our interpretation of the question is why should everyone not trade on an exchange or clearinghouse if that reduces systemic risk and improves transparency.

We do not believe that end-user derivatives pose systemic risk as they are not held for speculative purposes and they represent only a fraction of the estimated $600 trillion OTC derivatives market. Even if bid-ask spreads and fees on exchange traded derivatives are more economical for some end users, our assessment is that margin requirements of an exchange or clearinghouse would increase end-user hedging costs. Posting margin requires incremental capital and for us and many other corporations, and raising additional capital requires lead time and is relatively more expensive. This could provide disincentive to hedge normal business risks resulting in a greater threat to the stability of our financial system. Therefore, we strongly favor that for end-users, the decision to post margin be bilateral and not mandated by legislation.

Senate Committee on Agriculture, Nutrition & Forestry
Reforming U.S. Financial Market Regulation
Questions for the record
Mr. Neil Schloss
November 18, 2009

Question from Senator Debbie Stabenow

The national unemployment rate is 10.2 percent, while Michigan still leads the country with a rate of 15.1 percent. Currently more than 15 million Americans are looking for work--one-third of which have been jobless for over six months.

Since the start of the recession, the Economic Policy Institute estimates that 8.1 million jobs have been lost. However, I have read that Ford Motor Credit was able to keep dealers in business and customers in cars throughout the financial crisis. I understand that they were able to do so because they securitize their loans, thereby raising the funds they needed to keep lending to dealers and customers. It's my understanding that derivatives are integral to this securitization process. Please explain to me how derivatives work to facilitate your securitization and what would be the result of an inability to use derivatives to do this?

Ford's captive finance business relies heavily on asset-backed securitization markets to fund loans and leases to our U.S. dealers and consumers. At a time when many financial institutions were curtailing credit availability, Ford Credit continued to consistently support most of Ford's 3,000 plus dealers and Ford Credit's portfolio of more than 3 million active retail customer accounts during the credit crisis. At present, Ford Credit is providing financing to about 80% of the U.S. Ford and Lincoln Mercury dealers, up from an average of 77% in 2008.

Most of our securitization funding involves issuing floating rate debt purchased by investors in private and public transactions. Customized interest rate derivatives are required to eliminate differences between the floating interest rate on the debt and the fixed rate consumer loans being securitized. The interest rate risk between the securitization funding and the underlying securitized assets must be fully hedged to protect the investors against adverse changes in interest rates.

We are concerned that mandatory clearing and margin requirements on these customized derivatives could prevent Ford Credit and many others that use the securitization markets from efficiently accessing floating-rate note investors. Limiting investors will directly impact the amount of financing available to our dealers and customers.

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