Chatham Financial

Introduction & Summary

In a letter to U.S. Senator Harry Reid dated May 13, 2009, U.S. Treasury Secretary Timothy Geithner outlined proposed changes to the regulatory framework for over-the-counter (OTC) derivatives. Secretary Geithner's letter listed four broad objectives for regulatory reform: (i) to contain systemic risk, (ii) to promote efficiency and transparency, (iii) to prevent fraud and other market abuses and (iv) to ensure that OTC derivatives are not marketed inappropriately to unsophisticated users.

Chatham Financial (Chatham) agrees fully with the principles outlined in Secretary Geithner's letter. Since its founding in 1991, Chatham's mission has been to bring transparency to the OTC derivatives market as an independent derivatives and risk management advisor to well over a thousand companies[1]. Chatham, however, is concerned that an indiscriminate implementation of any new regulatory framework could have unintended consequences that are contrary to the principles outlined in Secretary Geithner's letter. These unintended consequences could disproportionately affect certain buy-side users of OTC derivatives whose interests, to date, have not been adequately represented in the public debate over regulatory reform. These end users, from Fortune 500 companies to small businesses, have used derivative instruments in a responsible manner to hedge legitimate business risks that they face - rather than for speculative purposes. Moreover, as sophisticated users of the specialized derivatives they require for risk management purposes, these businesses are not contributing to the systemic risk-related problems Secretary Geithner cited of undue volatility, fraud, or market abuse. We believe that affordable access to appropriate methods of hedging is vital to American businesses as they seek to mitigate risks and maintain their economic viability.

Containing Systemic Risk

In order to consider Secretary Geithner's primary regulatory objective, to contain systemic risk, we must first consider the size and composition of the OTC derivatives market. According to data released by the Bank of International Settlements (BIS) on May 19, 2009[2], the overall size of the global OTC derivatives market at the end of 2008 was $592 trillion by outstanding notional. Of the $592 trillion in outstanding notional, $419 trillion were interest rate contracts, $50 trillion were foreign exchange contracts, $42 trillion were credit default swaps, $6.5 trillion were equity-linked contracts, and $4.4 trillion were commodity contracts. Non-financial end users accounted for 10% of the interest rate derivatives market, 18% of the foreign exchange derivatives market, and 12% of the equity-linked derivatives market[3]. Furthermore, from the most recent data released by the Office of the Comptroller of the Currency, one can see that the top ten U.S. banks alone account for more than 32% of the global OTC derivatives market, by outstanding notional[4].

It is reasonable to assert that regulatory controls directed at containing systemic risk should be risk-based – that is, they should focus most intensively on the participants, and the particular products, that pose the greatest risk to the system.

[1] Please see the attached Annex.
[2] Please see http://www.bis.org/statistics/otcder/dt1920a.pdf.
[3] Please see http://www.bis.org/statistics/derstats.htm.
[4] Please see pg 22 of http://www.occ.treas.gov/FTP/RELEASE/2009-34A.PDF.

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Based on market statistics, and the relatively smaller volume of OTC transactions engaged in by non-financial customers entering the market for risk management purposes, it seems unlikely that such non-financial customers' use of OTC derivatives poses a threat to the U.S. or international financial system. Assigning the same regulations and standards that apply to dealers and speculators to responsible corporate hedgers, who are managing real economic risks, could have unintended consequences that should be carefully considered while drafting legislation.

It is also important to address the varying amounts of risk that different types of OTC derivatives pose to the financial system. For instance, the potential risk to the system due to changes in value of an interest rate swap (IRS) contract is vastly different than the potential risk due to changes in the value of a CDS contract. CDS can change in value by more than 50% overnight if an unexpected negative event occurs relating to the company that issues the reference obligation on which the CDS was written. Changes in the mark-to-market value of an IRS, however, follow changes in interest rates, which tend to be far less volatile, and which can be easily tracked by most end users throughout the course of a day. For an IRS contract with 10 years left until maturity, even a one-day 30 basis point movement in rates – a fairly drastic movement for interest rates - would cause a change in value that is less than 3% of the notional amount.

As we consider the participants and products in the OTC derivatives market that pose the greatest risks, future legislation should incorporate, and expand upon, what has already been committed to by the major market players. On June 2, 2009, a group of large dealers and buy-side institutions sent a letter to Federal Reserve Bank of New York President William Dudley (Dudley Letter) that outlines six key initiatives to which the largest participants in the OTC derivatives market are committing[5]. We endorse these efforts and feel that they will go a long way toward addressing Secretary Geithner's primary concern – protecting against risks to the financial system. We recommend that legislators and regulators assess the risk-reducing benefits of these measures as they draft proposed regulations that affect the OTC derivatives market as a whole.

Exchanges

Secretary Geithner stressed that market participants should use exchange-traded substitutes for OTC derivatives, where possible, as well as clearing houses. It is important to make a distinction between trading on an exchange and clearing a trade. An "exchange" refers to where the execution of a trade takes place. An exchange is a place, whether physical or electronic, where buyers and sellers engage in specific transactions with standardized terms according to specific rules that are determined by the exchange. Trades executed on an exchange are fully-collateralized through the exchange's clearing house. The "clearing" of a trade refers to a method by which two parties to a transaction (which may have been either executed privately or may have been executed on an exchange or electronic trading platform) agree to an assignment or "novation" whereby each party agrees to face an independent central counterparty. This central counterparty accepts and settles

[5] Please see a copy of the letter at http://www.newyorkfed.org/newsevents/news/markets/2009/060209letter.pdf.

payments made by the parties and guarantees the performance of the parties' obligations.

We agree with the many members of Congress who have pointed out that financial exchanges serve an important purpose as an efficient means of matching buyers and sellers and as vehicles for promoting transparency, price discovery, and liquidity in the markets that they serve. Financial exchanges (as well as clearing houses) function best when contracts are standardized. It is for this reason that exchange-traded derivatives do not always fit the highly specific and customized nature of the economic risks that American businesses seek to mitigate through use of OTC derivatives. Indeed, in his June 4, 2009 testimony before the U.S. Senate Committee on Agriculture, Nutrition and Forestry, Commodity Futures Trading Commission Chairman Gary Gensler acknowledged the need for customized hedges to match unique risks. Using a standardized exchange-traded contract to attempt to hedge a unique risk will result in a less effective hedge with (i) cash flows that do not offset the cash flows that were intended to be hedged or (ii) changes in value that only partially offset the changes in value intended to be hedged. This difference between the derivative and the risk that it is intended to hedge (known as "basis risk") could amount to greater uncertainty and a substantial financial burden to companies over time.

In addition to the lack of customization, exchanges have other significant limitations. Not all exchange-traded contracts are liquidly traded, and the cost of using illiquid exchange-traded contracts can be high. Exchange-traded contracts may also be unattractive to end users because they require that the parties fully collateralize the trades (please see the discussion on credit and collateral in the next section).

Central Clearing

Secretary Geithner also focused on increasing the use of central counterparties to reduce the risk that the OTC derivatives market poses to the financial system. Indeed, large volumes of OTC derivatives are already cleared through clearing houses located in the U.S. and Europe and the signatories to the Dudley Letter have committed to clearing additional OTC derivative product types in 2009 and 2010[6].

The alternative of submitting an OTC derivative for central clearing is compelling for an end user that can post cash or liquid collateral and is concerned about its counterparty's ability to satisfy its obligations. But many end users do not fit this description. If regulators mandate that certain OTC derivatives must be cleared by a central counterparty, many companies will be precluded from participating in the derivatives market unless they divert precious working capital that is essential to growing their core businesses. As a result, many of these firms will choose to remain un-hedged and will be exposed to economic risks, such as fluctuations in interest rates, currencies, and commodity prices. The aggregation of these un-hedged risks and reduced levels of working capital, as the case may be, could have a profoundly negative impact on the economy.

[6] Please see copies of press releases at http://www.lchclearnet.com/media_centre/press_releases/2009-05-27.asp and http://ir.theice.com/releasedetail.cfm?ReleaseID=375716.

We further note that this development would be patently unfair to many of these counterparties as: (i) these businesses are frequently entering the OTC derivatives market to hedge floating rate commercial debt and have limited access to fixed rate debt; (ii) they are willing to pay a premium that is intended to compensate the dealer for the credit risk and lack of posted cash collateral; and (iii) they frequently do not post cash collateral to the dealer with whom they trade in the OTC market, since the dealer is often also the business' lender and the derivative is cross-collateralized with the related debt.

As an example, take a manufacturer that needs to fund the construction of a new plant and the subsequent long-term financing once the construction is complete. Currently, a bank would offer the manufacturer a floating rate construction/term financing that is secured by a mortgage on the property. The manufacturer, however, would prefer a fixed rate, given the risk that rising interest rates could cause their interest expense on the loan to exceed the cash flows from operations. Because the bank funds itself with short-term funds, it desires to keep the loan floating, but is willing to offer the manufacturer an interest rate swap to fix the interest rate on the loan. The swap would be customized to match the expected draw schedule during construction and the expected amortization schedule of the permanent financing upon completion of construction. Furthermore, the swap would be secured by the mortgage on the property and the plant's cash flows. If legislators remove access to this type of customized derivative, or mandate that all derivatives are collateralized in full by cash or liquid securities, thousands of companies like the manufacturer will not be able to hedge and will be exposed to an additional risk – interest rate risk – that could cause them to lose money even if their core businesses are operating profitably. Moreover, this could have the unintended consequence of exposing financial institutions to additional interest rate risk if there is an increase in borrower demand for fixed-rate loans. The combination of funding at short-term variable rates and lending at long-term fixed rates was a major component of the savings and loan crisis of the 1980s.

Chatham feels that regulators should continue to allow dealers and other financial institutions to use their own balance sheets, where appropriate, to provide credit to end users that are prudent consumers of derivatives and do not pose a risk to the financial system. If the trading volumes of an individual end user exceeded a critical level, it would be reasonable for regulators to subject this firm to more stringent clearing or collateral requirements.

Accounting Considerations

Many derivative end users that will be affected by the proposed changes are companies that prepare financial statements in accordance with Generally Accepted Accounting Principles in the United States (US GAAP). Under US GAAP, derivatives are subject to the accounting and financial reporting requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted (FAS 133). FAS 133 is the accounting standard that requires all derivatives to be recorded on a company's balance sheet at fair value. Earnings recognition of changes in fair value of derivatives is dependent upon the company's intended use of the derivative, as well as a company's ability (and desire) to comply with the strict requirements to obtain special "hedge accounting" under FAS 133. All changes in fair value of derivatives that do not qualify for hedge

accounting are recognized directly in earnings, thereby resulting in earnings volatility due to the mark-to-market valuations of the derivatives each period. Hedge accounting under FAS 133 allows a company to appropriately align the accounting with the underlying economics of a transaction by matching the timing of the earnings recognition of the derivative with the asset or liability being hedged. As hedge accounting can significantly reduce a company's earnings volatility, many companies seek to execute derivatives that will meet the strict criteria to qualify for hedge accounting under FAS 133.

Requiring the use of standardized derivative contracts rather than customized OTC contracts introduces economic and accounting risks to companies. Currently, companies can customize the economic terms of an OTC derivative to exactly (or very closely) match the economic terms of the asset or liability that the company is hedging (the hedged risk). Standardized derivative contracts will not allow for such a precise matching of economic terms, thereby introducing real economic risk to companies that are attempting to reduce risk through the use of derivative instruments. Standardized derivative contracts will also introduce accounting risk to companies through increased earnings volatility under the FAS 133 hedge accounting model, which is largely dependent on the ability to match the economic terms of the derivative to those of the hedged asset or liability.

Under the FAS 133 hedge accounting model, companies must assess the effectiveness of the derivative in offsetting the hedged risk over the life of the hedge. The inherent mismatches in economic terms between the derivative and the hedged risk that standardized derivative contracts would create could be large enough to cause the derivative to fail to qualify for hedge accounting. In those situations, companies will be forced to recognize all changes in fair value of the derivatives directly in earnings, which will significantly increase earnings volatility in the company's financial statements for many hedging relationships that would otherwise qualify for hedge accounting with an OTC derivative. Even in instances when a standardized derivative contract qualifies for hedge accounting, companies still will be forced to recognize more earnings volatility than with a perfectly matched OTC derivative, as the economic mismatches will be a source of "ineffectiveness" in the hedge that must be measured and recognized in earnings each period. In addition, with standardized derivative contracts, simplified approaches to assessing effectiveness and quantifying hedge ineffectiveness under FAS 133 will no longer be available (due to the economic mismatches); therefore, more companies will be required to perform complicated statistical analyses or other "long-haul" approaches to qualify for hedge accounting. As a result, standardization of derivative contracts will significantly increase the complexity of applying hedge accounting under FAS 133. As similar hedge accounting provisions and requirements exist in international accounting and reporting standards, most notably under International Accounting Standards No. 39, *Financial Instruments: Recognition and Measurement,* adopting IFRS[7] would not present a solution to the accounting risks that standardized derivatives introduce to companies.

The economic and accounting risks introduced by standardized derivative contracts may, unfortunately, discourage prudent risk management currently achieved through OTC derivatives, which would counteract efforts to reduce and contain systemic risk.

[7] International Financial Reporting Standards

While accounting and disclosures alone cannot contain systemic risk, or prevent fraud and other abuses, we do believe that the accounting standards are much more suited to OTC derivatives than standardized contracts and provide for significant benefits to legitimate and prudent risk management strategies.

Promoting Transparency and Efficiency

We recognize the need for increased regulatory controls over the participants and products that pose the greatest threat to the financial system. We also recognize that while a particular participant or product in the OTC derivatives market may not currently pose a threat to the financial system, changes in economic conditions or trading volumes could be such that this participant or product may pose a significant threat to the system in the future. We believe that regulators should determine an acceptable level of credit exposure and require market participants with net exposures that exceed this level to report the details of all OTC derivatives to a central trade repository. This places the onus of reporting on participants representing the greatest risk to the financial system. We also stress that efforts should be made to (i) limit the costs of these reporting requirements and (ii) allocate these costs among the market participants in a fair manner.

Preventing Market Abuse & Ensuring That Derivatives Are Not Marketed Inappropriately to Unsophisticated Users

We support completely the notion that businesses that hedge should understand the trades that they are executing, the risks associated with these trades, and how these risks could change over time. We, however, want to stress that a company's level of understanding and sophistication is not determined by its size. Simply put: being small does not make a company unsophisticated and being large does not make a company sophisticated. We feel that a focus on disclosures, rather than minimum size requirements, is in line with the regulatory goals of promoting transparency and preventing market abuse. Size requirements could have the unintended consequence of creating a barrier to entry that prevents sophisticated and informed end users from hedging real economic risks.

Regulators could consider focusing on new disclosure requirements aimed at promoting the informed use of OTC derivatives. We note that it is often the structure of the hedge, and not the sheer size, that can create unintentional or unforeseen results for the unsophisticated counterparty. Regulators could require that disclosures include information on how the derivatives are valued and examples showing how the value would change, relative to the hedged item, under stress tests or shock scenarios. Regulators could require that all participants state whether the derivative trade is for speculative or hedging purposes and, if for hedging purposes, the nature of the risk that is being hedged.

We place equal importance on Secretary Geithner's reference to the inappropriate marketing of OTC derivatives. There have been several reported cases of abuse and inappropriate marketing, most of which relate to one particular constituency of end users: municipalities using derivatives to hedge public bond issuances, many cases of which are now embroiled in criminal and civil litigation. This may point to a need for enhanced oversight of the municipal derivatives market and/or encouraged use of competent advisors. Here, as with the regulatory framework as a whole, we feel that a targeted application, rather than a one-size-fits-all approach, is merited and would have the best results.

Conclusion & Proposals

- In crafting measures to reduce systemic risk, legislators and regulators must be careful to balance the appeal of a one-size-fits-all solution with the complex and diverse realities and needs of the many participants in the OTC derivatives market.

- New regulations should focus most intensively on the participants in the OTC derivatives market that are large enough to pose a threat to the financial system.

- The recent disruptions relating to OTC derivatives were not caused by the relatively small segment of the market made up of U.S. businesses that enter into OTC trades judiciously for the purpose of mitigating risk.

- Legislators and regulators should continue to allow dealers and financial institutions to use their own balance sheets, where appropriate, to provide credit to end users that do not pose a threat to the financial system and that use OTC derivatives to hedge real economic risks.

- Customized OTC derivatives serve an important risk-reducing function for community banks, corporations, municipalities, and private end users throughout the U.S. and around the world. It is crucial to maintain this customization.

- Companies that are forced to use standardized derivatives to hedge unique risks may be faced with significantly increased earnings volatility and accounting complexity.

- Exchanges and clearing houses do not meet the needs of many U.S. businesses that use OTC derivatives to hedge unique risks.

- Regulators can improve market transparency and reduce market abuses by requiring that the largest OTC counterparties (by net exposure) report the details of all their OTC derivatives to a central trade repository.

- We would warn against drafting legislation that makes access to customized risk management tools either too difficult or too expensive to attain.

ANNEX: About Chatham and Our Clients

Founded in 1991, Chatham is the largest independent interest rate and foreign exchange derivatives advisory firm. With offices in suburban Philadelphia, Denver, London, Singapore, and Krakow, we serve over 1,000 leading private and public companies worldwide across many sectors, including Community & Regional Banking, Consumer Products & Retail, Healthcare, Industrial Manufacturing, Institutional Investment, Real Estate, and Technology, Telecommunications & Media. Chatham has clients located in 45 U.S. states and in every major metropolitan area.

Chatham educates and advises clients on the use of OTC derivatives to mitigate interest rate and foreign currency risk that they face in the normal course of business.

As a 100% employee-owned, view-neutral consulting firm, we are independent and not associated with any bank. Since 1991, we have advised on more than $1.7 trillion in hedging transactions, by notional amount, currently averaging approximately $1.3 billion in hedging daily. We have not executed any credit default swaps on behalf of our clients.

Chatham's areas of core expertise:

- Interest Rate Risk Management
- Foreign Currency Risk Management
- Accounting Compliance (FAS 133, IAS 39, and FAS 157)
- Derivative Valuations
- Debt Management and Valuations
- Capital Advisory