

**Hearing before the Subcommittee on Capital Markets and Government
Sponsored Enterprises – Committee on Financial Services**

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“Legislative Proposals Regarding Derivatives and SEC Economic Analysis”

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Good morning Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. I am Thomas C. Deas, Jr., Vice President and Treasurer of FMC Corporation and Chairman of the National Association of Corporate Treasurers, an organization of treasury professionals from several hundred of the largest public and private companies in the country. FMC and NACT are part of the Coalition for Derivatives End-Users (the “Coalition”). Our Coalition represents thousands of companies across the United States that employ derivatives to manage business risks they face every day. Thank you very much for giving me the opportunity to speak with you today about derivatives regulation.

End-Users’ Concerns with Derivatives Regulation

The Coalition supports your efforts to oversee the implementation of the Dodd-Frank Act. We very much appreciate the strong bipartisan efforts by the Members of the Committee on Financial Services on behalf of American companies who use derivatives to manage many of the risks they face in running their businesses every day. We recognize the need to redress problems with derivatives experienced during the financial crisis in 2008. I want to assure you that FMC and other end-users were not and are not engaging in risky speculative derivatives transactions out of which some of that turmoil arose. End-users comprise less than 10 percent of the total over-the-counter (“OTC”) derivatives market and do not significantly contribute to systemic risk. We believe there is broad agreement with the concept that end-users should not be subject to regulations designed to reduce the risk of swap dealers and others who maintain open or systemically significant derivatives positions and engage in market-making activities. At the time of passage of the Dodd-Frank Act, we understood from a plain reading of the legislative language as well as from letters and colloquies by the principal drafters, that end-users would be exempted from certain provisions intended to reduce the inherent riskiness of swap dealers’ activities. In addition, recognizing the potential adverse consequences on the competitiveness of American business and ultimately on

jobs here at home, regulators vowed to keep their actions in sync with those of our international trading partners and not impose any undue regulatory burdens on U.S. end-users.

However, at this point over two-and-a-half years after passage of the Dodd-Frank Act, there are several areas where continuing regulatory uncertainty compels end-users to appeal for legislative relief from actions we believe will raise costs unnecessarily and hamper our ability to manage business risks with properly structured OTC derivatives. Among several areas of concern, I would like to invite your attention to three in particular:

- Margining of derivatives,
- Inter-affiliate derivatives transactions, and
- Capital requirements for derivatives transactions.

Margining of Derivatives

Please allow me to illustrate end-users' use of derivatives with a specific example from my company. FMC is the world's largest producer of natural soda ash, the principal input in glass manufacturing, and is one of the largest employers in the state of Wyoming. We are also developing innovative new chemically related applications that scrub sulfur compounds from flue gases of factories and power plants. We can mine and refine soda ash products in southwestern Wyoming, ship them to South Asia, and deliver them at a lower cost and with higher quality than competing Chinese producers. Energy is a significant cost element in producing soda ash and FMC protects against unpredictable fluctuations in future energy costs with OTC derivatives to hedge natural gas prices. These derivatives are executed with several banks, all of which are also supporting FMC through their provision of \$1.5 billion of credit. Our banks do not require FMC to post cash margin to secure mark-to-market fluctuations in the value of derivatives, but instead price the overall transaction to take this risk into account. This structure gives us certainty so that we never have to post cash margin while the derivative is outstanding. However, if we are required by the regulators to post margin, we will have to hold aside cash and readily available credit to meet those margin calls. Depending on the extent of price movements, margin might have to be posted within the trading day as well as at the close of trading. Because failure to meet a margin call would be like bouncing a check, and would constitute a default, our corporate treasury would act very conservatively in holding cash or immediately available funds under our bank lines of credit to assure we could meet any future margin call in a timely fashion and with a comfortable cushion.

Adopting more conservative cash management practices might sound like an appropriate response in the wake of the financial crisis. However, end-users did not cause the financial crisis. End-users do not contribute to systemic risk because their use of derivatives constitutes prudent, risk mitigating hedging of their underlying business. Forcing end-users to put up cash for fluctuating derivatives valuations means less funding available to grow their businesses and expand employment. The reality treasurers face is that the money to

margin derivatives has to come from somewhere and inevitably less funding will be available to operate their businesses.

FMC and other members of the Business Roundtable estimated that BRT non-financial member companies would have to hold aside on average \$269 million of cash or immediately available bank credit to meet margin calls, assuming a 3 percent initial margin and no variation margin. In our world of finite limits and financial constraints, this is a direct dollar-for-dollar subtraction from funds that we would otherwise use to expand our plants, build inventory to support higher sales, undertake research and development activities, and ultimately sustain and grow jobs. In fact, the study extrapolated the effects across the S&P 500, of which FMC is also a member, to predict the consequent loss of 100,000 to 120,000 jobs. The effect on the many thousands of end-users beyond the S&P 500 would be proportionately greater. We would also have to make a considerable investment in information systems that would replicate much of the technology in a bank's trading room for marking to market and settling derivatives transactions.

Let me give you a direct example of why our banks have agreed that cash margin is not necessary for FMC's derivatives trades. Because we are always hedging an underlying business risk, if a current valuation of a derivative is underwater, then the risk we are hedging must be in the money, resulting in a net neutral position. To continue with our natural gas hedging example, as the price of gas fluctuates, the valuation of the derivative changes by an equal and opposite amount in relation to our natural gas purchases. If the price of gas falls by 10 percent, then the value of the derivative is out of the money by the same amount. This results in no net gain or loss when the derivative and the underlying exposure are valued together at any point in time. Although we have to pay the bank an amount equal to the 10 percent fall in gas prices for the agreed volume hedged, we owe that much less for the gas we are buying. FMC benefits from not having unpredictable demands on liquidity. For this balanced structure, we agree to a small markup payable at maturity of the derivative transaction I've just described. This is far cheaper in both financial and administrative cost than if we had to keep idle cash or immediately available credit to meet cash margin postings and undertake significant information systems investments. Customized OTC derivatives allow us to operate with predictable energy costs, reducing our business risk.

By forcing end-users to post cash margin, the regulators will take the balanced structure I've just described and impose a new risk. Treasurers will have new and unpredictable demands on their liquidity. Swap dealers are market makers who take open positions with derivatives and we agree central clearing and margining is appropriate for them. However, since end-users are balanced, with derivatives exactly offsetting underlying business risks, forcing them into the swap dealers' margin rules adds the considerable risk for end-users of having to fund frequent cash margin payments. This will introduce an imbalance and new risks onto transactions that are matched and will settle with offsetting cash payments at maturity.

As the Members of this subcommittee well know, the Prudential Banking Regulators; consisting of the Treasury, the Federal Reserve, FDIC, FCA, and FHFA; have proposed rules that would subject end-users to uncertain future margining requirements. This puts these regulators out of step not only with proposed margin rules from the Commodity Futures Trading Commission (“CFTC”), but also with proposed rules from the European Union’s G-20 Working Group on Margining Requirements. This complements other actions by the European Union to provide a very clear exemption from margining for its end-users. The Coalition commends the bipartisan efforts of Members of this Committee to redress the problem for American industry through support for such bills as H.R. 634, the *“Business Risk Mitigation and Price Stabilization Act of 2013”*.

Inter-affiliate Derivatives Transactions

Throughout the legislative and rule-making processes surrounding the Dodd-Frank Act, the Coalition has advocated for strong regulatory standards that enhance financial stability while avoiding needless costs. New regulations are scheduled to become effective within months that could impose on many end-user companies additional costs and regulatory burdens in connection with long-standing, widely used procedures they employ to net exposures within their corporate groups. The Commodity Futures Trading Commission has recently announced important relief in the form of a final rule and “no-action” recommendation from two of the CFTC’s divisions. Assuming several conditions are met, the final rule and the no-action relief would exempt many inter-affiliate swaps from mandatory central clearing and some reporting requirements. However, there are several areas where sought-after relief was not provided. The Coalition strongly supports H.R. 677, the *“Inter-Affiliate Swap Clarification Act”*, which would address the remaining uncertainty and impermanence of the CFTC’s regulations. Among the areas that still need legislative action are:

- Financial entity designation – Many central treasury or hedging units, even those part of a corporate group headed by a parent company that is clearly a non-financial entity, run the risk of themselves being categorized as financial entities subject to mandatory central clearing and margining requirements beginning on June 10, 2013.
- Internal swaps with majority-owned affiliates in the European Union, Japan, or Singapore would still be subject to mandatory clearing unless certain external clearing or margining conditions are met.
- Internal swaps with majority-owned affiliates located in jurisdictions outside the U.S., European Union, Japan, or Singapore are required to clear their market-facing swaps as a condition of electing the inter-affiliate clearing exemption (subject to certain temporary conditions), even if the foreign jurisdiction does not require such swaps to be cleared or even have clearing available for the particular type of swap.

Treasurers of non-financial end-users who operate centralized treasury units that serve the risk-mitigating function of aggregating exposures on the books of a special-purpose subsidiary within their corporate group, netting the inter-affiliate exposures, and then entering into smaller derivatives with a bank or other swap dealer for the net amounts, could have to wind down those efficient units or meet burdensome new regulatory requirements that will be hard to justify. The remaining alternative would be to retain more risk because hedging would no longer be cost effective. As pointed out above, these treasury centers are subject to designation as financial entities, in which case they would be denied the end-user clearing exemption despite the fact that they are executing trades for non-financial end-user affiliates.

Capital Requirements for Derivatives Transactions

With your help, end-users could successfully navigate the regulatory issues I've described, obtaining necessary relief from the most burdensome rules on margining, mandatory clearing, real-time reporting on both third-party and inter-affiliate derivatives transactions, only to find that the uncleared OTC derivatives they seek to continue using have become too costly because of much higher capital requirements. The Prudential Banking Regulators have proposed rules entitled "Advanced Approaches; Risk-Based Capital Rule; Market Risk Capital Rule" (the "Capital Proposal"). The Capital Proposal implements a new Credit Valuation Adjustment ("CVA") that would increase the current capital bank counterparties would have to hold against derivatives in anticipation of a possible future deterioration in the financial markets such as that experienced in 2008. Our analysis shows the cost for my company to enter into a 7-year cross-currency swap could increase by a factor of three compared to current rules. Less financially strong companies will see significantly larger increases.

European policy makers seem to be enacting capital charges on derivatives positions significantly more favorable to end-users than the Capital Proposal of the U.S. Prudential Banking Regulators. Their approach is to recognize that end-users' hedging activities are in fact reducing risks; and so, should attract less capital than activities of financial entities keeping open positions or making markets in derivatives. They propose to exempt non-financial end-users from the additional capital requirements for CVA risk. The absence of a U.S. exemption will put American companies at a meaningful competitive disadvantage compared to our European competitors.

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

Summary

Let me take a moment to summarize our principal concerns with the application of derivatives regulation to end-users:

- First, we are concerned that the regulations have imposed an uncertain framework requiring several types of end-user derivatives to be centrally cleared with mandatory posting of daily cash margin, potentially diverting billions of dollars from productive investment and employment into a new regulatory levy.
- Second, even if the final regulations clearly exempt end-users from margining requirements, we still have the risk that the banking regulators will require excessive capital be held in reserve against uncleared over-the-counter derivatives – with the cost passed on to end-users as they attempt to manage their business risks. The unintended consequence of punitive capital requirements could be for some end-users to cease hedging risks or to pay hedging costs that put them at a disadvantage against foreign competition operating where end-user exemptions have been made more effective.

Conclusion

Thank you again for the opportunity to testify today on these important issues.

We are very concerned that an impending regulatory burden on end-users of derivatives will result in higher costs to Main Street companies that will limit their growth, harm their international competitiveness, and ultimately hamper their ability to sustain and, we hope, grow jobs.

The consequences of getting derivatives regulation wrong will be borne by American business and ultimately our fellow citizens.

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