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Senate Ag hearing questions new rules for derivatives markets

By Jon H. Harsch

In the Senate Agriculture Committee hearing on financial regulatory reform legislation Nov. 18, Democrats as well as Republicans joined derivatives market users in warning against imposing clearing and margin requirements which could make risk protection too expensive for farmers and other small businesses.

Mark Boling, Executive VP & General Counsel for Southwestern Energy Company, a Houston-based natural gas production company, warned specifically that while his company supports increased market transparency and reporting:

> "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 requirements."

Boling called for financial reform legislation to draw 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." He said legislation should "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."

Agriculture Committee Chair Blanche Lincoln (D-AR) opened the hearing by stressing the need for financial reform "to give comfort to consumers and businesses so that they can trust our markets to determine fair prices and to help manage risks." She said a decade of deregulation "devastated our economy" and that "a steady stream of market calamities has exposed fatal flaws in our regulatory system." But she also warned against the tendency to "overreact or veer too far in the other direction."

Ranking Member Sen. Saxby Chambliss (R-GA) accepted the need for “possibly some regulatory changes” but warned against “politicizing a solution.” He asked “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?” He also pointed out the need to ensure that any reforms do not “hamstring” the Farm Credit System and Farmer Mac.

Sen. Debbie Stabenow (D-MI) voiced her concern that many of Michigan’s small manufacturers would find it impossible to post collateral. Commodity Futures Trading Commission (CFTC) Chair Gary Gensler acknowledged the problem but said that Michigan’s businesses are suffering from the financial collapse triggered by unregulated markets, “so that is the risk we are trying to protect against.” He added that while imposing margin requirements will raise costs, greater market transparency will lower costs and reduce risk.

Roosevelt Institute Director of Economic Policy Robert Johnson, speaking for the Americans for Financial Reform, acknowledged that the cost of using derivatives markets will increase if the current “deeply flawed” system is “replaced by more robust and healthy market structures.” But he argued that the current pricing system in fact provides derivatives users “an unhealthy subsidy” that became visible when AIG’s collapse revealed it was under-pricing the risks it took on. That under-pricing led to the $180-billion bailout paid for by American taxpayers. He warned that providing exemptions for end users could once again “enable the largest market participants to remain in the shadows where they earn extraordinary profits but put society and the public treasury in peril.”

Repeating points he’s made in previous hearings, CFTC Chair Gensler told the committee that he and the administration are pursuing four priorities:

- “First, all standardized OTC derivative transactions should be moved onto regulated transparent exchanges or trade execution facilities.”
- “Second, all non-cleared transactions should be reported to a trade repository that makes the data available to regulators.”
- “Third, data on OTC derivatives transactions should be aggregated and made available to the public.”
- “Fourth, stringent recordkeeping and reporting requirements should be established for swap dealers and major swap participants and vigorously enforced.”

Emerging from the hearing’s lively debate over issues like possible unintended consequences of regulatory reform and how to define “standardized transactions,” Gensler was upbeat. He explained he’s working with members and their staff in both the House and Senate on finalizing reform proposals to promote transparency and “bring as many transactions into clearing as possible” with any exemptions “narrowly crafted.”

Gensler said it’s “truly historic” to have achieved “a broad consensus to move this forward” and make major swap participants subject for the first time to “full registration and regulation for capital and margin, business conduct, record-keeping, and reporting.” But he also cautioned that as part of the normal legislative process, many changes are possible before there’s a final financial reform package. Senator Lincoln noted that the process will continue on Dec. 2nd with Treasury Secretary Timothy Geithner testifying in the next Senate Agriculture Committee hearing on financial regulatory reform.

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