Testimony of Blythe Masters
JPMorgan Chase & Co.
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Chairwoman Lincoln, Ranking Member Chambliss, and Members of the Committee, my name is Blythe Masters, and I am a Managing Director and Head of the Global Commodities Group at JPMorgan Chase & Co. J.P. Morgan's commodity business provides thousands of commercial, industrial and financial customers with risk management and transactional services in both physical and financial commodities globally. Thank you for inviting me to testify at today's hearing.

J.P. Morgan believes that reform of the regulatory framework for over the counter (OTC) derivatives is necessary. The experience with OTC derivatives during the financial crisis highlighted three major issues that will be more than adequately addressed by some of the proposed reforms now under discussion: lack of transparency in the market, particularly to regulators; excessive interconnectedness among major financial institutions; and absence of a systemic risk regulator to intervene in the event of excessive risk-taking by under-regulated, but systemically relevant, companies, such as AIG. There is a welcome degree of consensus among market participants and regulators about what needs to be fixed. As the legislative process moves forward, and the Committee considers the details of these reforms, it is critical for legislation to recognize the essential role these markets play in helping companies across the nation hedge their risks and thereby gain access to credit necessary for economic growth and job creation. We hope the Committee will consider the costs and benefits of proposals as they formulate their approach.

Two of the key legislative proposals to reform the market are clearing and exchange trading requirements, and I will address each in turn.

Clearing

As the Committee heard during other hearings on this topic, clearing of OTC derivatives transactions through regulated clearinghouses provides critical stability benefits to the global financial system and must be mandated; however, that mandate must take into account two important facts:

1. Not all OTC market participants are capable of clearing. At the November 18 hearing held by this Committee, end-users of OTC derivatives unanimously testified that OTC derivatives are essential risk management tools, that clearing such transactions would result in significant liquidity difficulties, and that the attendant costs would in some cases be insurmountable, preventing them from managing risk and inhibiting their growth. Moreover, those costs would produce no benefit to the financial system because end users' use of OTC derivatives had nothing to do with the financial crisis and OTC derivatives entered into by end-users did not contribute to the problems facing our financial system.

2. Not all OTC derivatives are capable of being cleared. To clear a type of OTC derivatives product, a clearinghouse must establish relatively standard terms that frame the

contract to be cleared, a formula for determining initial margin, a method for pricing to determine variation margin, and systems for processing transactions submitted for clearing as well as for payments and collateral with respect to those transactions. This work is sophisticated and expensive, and it would not be feasible, and in all likelihood would be risky, for a clearinghouse to create a cleared version of every OTC derivatives contract that might be traded. Clearinghouses will, and do, focus on the products that trade with sufficient frequency so as to enable them to manage their risks appropriately without having to impose initial margin requirements at a level that would make trading uneconomical. Importantly, clearability should not determine whether end users should continue to have access to these products. As end users have testified, their risks can be highly specific and they often require customized products, so banning forms of transactions would only prevent them from managing those risks.

For the purposes of determining a clearing mandate, recognition of these two facts can be expressed in two questions: who has to clear, and what has to be cleared? The answer to the first question is more important in our view because market participants, rather than transactions, create systemic risk. J.P.Morgan believes that clearing should be required among systemically important institutions whose failure could destabilize the financial system and thus threaten the entire economy: derivatives dealers and major swap participants. Derivatives dealers are well known; as Chairman Gensler testified, these are the fifteen to twenty large, complex financial institutions that are at the center of today's global derivatives marketplace. Major swap participants, on the other hand, are creatures of legislative definition. There are common elements in the definitions contained in recent legislation proposed in Congress, and J.P.Morgan believes the key determinant should be the systemic risk posed by an entity's outstanding derivatives transactions.

Entities that are not dealers or major swap participants should be exempt from the clearing mandate. These entities, the vast majority of which J.P.Morgan expects to be commercial end users, need OTC derivatives but do not pose systemic risk to the financial system. Further, there is no benefit to be gained from requiring them to clear but, as they have testified, there is significant cost. Nonetheless, there have been arguments made that these entities still should be required to clear because the credit risk from their derivatives transactions, in the aggregate, could imperil the dealers with whom they transact. Those arguments are wrong; they misstate the size and the nature of the risk. For example, J.P.Morgan's aggregate derivatives-related credit risk to non-financial entities as of the fourth quarter of 2008 was approximately $59 billion. Our Tier 1 capital as of that time was approximately $120 billion. To put our derivatives credit risk in context, our total loan exposure at that time was $745 billion. Derivatives credit risk is qualitatively the same as loan credit risk, and both should be encouraged and managed in a safe and sound manner. We lend to American companies, and using the same credit analysis, we provide risk management products to American companies.

There have also been proposals suggesting that end-users be required to clear and that the requisite collateral would be lent to them by banks under margin financing agreements. These arguments ignore the balance sheet impact that margin loans would have on end-users as well as the costs of such loans to end-users as discussed by companies at a hearing before this Committee two weeks ago. Margin loans would double the size of an end-user's liabilities because the loan would be in addition to the derivatives exposure, thus limiting the ability of the end-user to borrow for investment and jeopardizing its credit rating. Furthermore, the interest

rate on margin loans would be variable and could not be hedged, so the end-user would be exposed to additional risks beyond those it sought to hedge, which in some cases could undermine the entire purpose of hedging. Lastly, it is not at all certain that margin financing would be available at all times in the amounts an end-user would need for the duration of its derivatives transaction. The current method by which end-users negotiate and execute OTC derivatives is suitable for them, as they have testified, and does not harm the financial system. Given the material impact such a change would have on end users, the certain costs and uncertain benefits of this proposal should be carefully considered.

With regard to what should be cleared, attempts have been made to define the characteristics of "standardized" transactions and to delegate the power to make the relevant determination with respect to particular transactions. J.P.Morgan believes this effort is fundamentally flawed. No definition can be precise enough to capture all these characteristics, nor can it evolve over time as new risk management products are introduced, in each case leaving open the possibility of regulatory arbitrage as products might be structured in such a way as to not meet the definition. Delegation to regulators, clearinghouses or other arbiters has also been shown to be problematic. The end result likely would be a body of financial regulation to rival the tax code in length and complexity.

J.P.Morgan believes the better approach is to address the issue causing systemic risk: the degree of interconnectedness between systemically significant institutions (i.e., dealers and major swap participants). To achieve the goal of minimizing the extent to which a single dealer's or major swap participant's default could harm other dealers and major swap participants and the financial system overall, we propose that the regulators require that the cleared exposures of each dealer and major swap participant be greater than a stated percentage of the overall exposures of the dealer or major swap participant for each asset class. This percentage would be determined by the CFTC for commodities-based swaps and the SEC for securities-based swaps -- in each case jointly with the prudential regulator, since the prudential regulator must be involved in efforts to address systemic risk. These percentages should vary by asset class and by institution to reflect the degree to which end-users enter into risk management transactions in that asset class and the capital strength, and other systemic attributes, of the relevant institution.

J.P.Morgan believes this might be a useful approach because it would eliminate the conceptual problems and other issues with defining what transactions are "standardized", it relies on known, easily understandable information (all regulated dealers already report this information to their regulators), it is flexible (the regulators can change percentages over time, as they see fit), and it provides incentives to dealers and major swap participants to clear their exposure between themselves, thus minimizing interconnectedness. This approach, combined with greater capital requirements for non-cleared exposures and zero capital requirements for cleared exposures, would address systemic risk in a comprehensive manner using existing information with no room for gamesmanship or evasion.

Trade Execution

On November 18, Chairman Gensler testified that "transparency benefits the marketplace," and J.P.Morgan wholeheartedly agrees and supports efforts to increase transparency in the OTC derivatives market. Transparency, however, is a means to a policy end, rather than an end in

itself. J.P.Morgan believes the policy objective is a well-functioning market for risk management. Well-functioning is not measured only by transparency but also by liquidity (the ability to execute transactions), volatility (the rate of change in market prices), transaction costs and other factors. It does not benefit market participants to have complete price transparency when the result is inability to execute risk management transactions because of lack of liquidity or sudden movements as soon as a transaction is executed. Consequently, efforts to improve transparency in the OTC derivatives market must be considered in light of what effects they could have on other characteristics of this market and on its participants.

To that end, J.P.Morgan supports three of the four priorities proposed by the Administration and supported by Chairman Gensler to improve transparency. J.P.Morgan supports reporting all non-cleared transactions to a trade depository that makes the data available to regulators as well as aggregating data on OTC derivatives transactions and making it available to the public. J.P.Morgan also supports establishing stringent recordkeeping and reporting requirements for swap dealers and major swap participants and vigorously enforcing those requirements. However, while we believe post-trade price reporting can be useful in providing end users with pricing information, we do not believe that requiring cleared transactions to be moved onto exchanges would provide any additional benefits but would, rather, destroy market liquidity, disrupt efficient risk transfer and significantly affect end users' ability to transact.

Mandatory exchange-trading would require dealers to post their risk positions through the central limit order book operated by the exchange. Posting large or longer-term risk, the kind of risk that arises in OTC derivatives transactions and the kind of risk for which there is not a natural pool of liquidity on an exchange, would alert the rest of the market to a dealer's risk position and would move the market against that dealer, making it much more expensive and risky for that dealer to execute its hedging transaction. Dealers would be reluctant to put their capital at risk when hedging the OTC transaction on exchange and so would increase costs of the OTC transaction accordingly, if they were to execute the transaction at all. The result would be fewer risk management transactions executed in smaller amounts at greater cost to end-users.

In testimony, Chairman Gensler cited the presence of information deficits in the OTC derivatives market that necessitate the requirement to move OTC transactions to exchanges. J.P.Morgan agrees that information deficits for the public and regulators must be remedied through clearing and transaction reporting but disagrees that market participants have such a deficit. Although the CFTC notes the imperative of price transparency as justifying an exchange trading mandate, we are not aware of price transparency being raised as an issue in any of the testimony or publicly available letters from end-users on OTC derivatives, though they have been outspoken in expressing concerns about other elements of the legislative proposals. The OTC derivatives market is extremely competitive and the fifteen to twenty dealer institutions that Chairman Gensler notes are central to the market compete tenaciously on the basis of price. Competition between these dealers, augmented by numerous voice and electronic brokerage firms that disseminate pricing information, results in transparent price discovery. (By analogy, there are a small number of mobile phone companies in the US but tremendous price-based competition among them. Similarly, to preserve economies of scale and adequate levels of capitalization, competition ensures a balance between scale and numbers of firms competing in OTC derivatives markets). That pricing information currently is accessible to all market participants through electronic screens and pricing services that are widely available, through trade information warehouses, through advisory firms that provide execution services to end-users

and even through daily newspapers and their websites (both the Wall Street Journal and the Financial Times publish daily pricing information for OTC derivatives referencing interest rates and currencies). Simply put, the facts do not support the rationale for an exchange-trading requirement.

J.P.Morgan believes all market participants should continue to have the ability, as they currently do, to choose whether to execute their risk management transactions on exchange or OTC. Transparency can be achieved through increased reporting and monitoring without mandatory exchange trading which deprives participants of this choice. (For example, the US treasury security market, which exists entirely OTC, is an enormously transparent market.) The systemic benefits that arise from clearing are not at all enhanced by exchange trading, and in fact it is likely that mandatory exchange trading will result in overall damage to the market.

Conclusion

J.P.Morgan is committed to working with Congress, regulators and other market participants to create an appropriate regulatory framework for OTC derivatives that provides comprehensive oversight, ensures systemic stability and promotes market transparency. We support many of the proposals that have been proffered to achieve these policy objectives. Specifically, we believe in comprehensive oversight of dealers and major swap participants, reporting requirements for all transactions, mandatory clearing requirements for dealers and major swap participants with significant outstanding exposures and end-of-day position reporting to the public of the aggregate positions of dealers and major swap participants, similar to the Commitments of Traders report published weekly by the CFTC. As always, we believe regulators should have access to any information at any time and in any form.

Thank you, Chairwoman Lincoln and Ranking Member Chambliss. I appreciate the opportunity to testify, and look forward to your questions.