Testimony of Jiro Okochi
Chief Executive Officer & Co-Founder
Reval.com, Inc.

Before the U.S. Senate Committee on Agriculture, Nutrition and Forestry
On
OTC Derivatives Reform and Addressing Systemic Risk

December 2, 2009

Introduction

Good morning Chairman Lincoln, Ranking Member Chambliss and Members of the Committee. Thank you for the opportunity to testify before you today on the topic of reforming the OTC derivatives market.

My name is Jiro Okochi, and I am the CEO and Co-Founder of Reval, a company which provides a web-based solution that helps over 375 companies better manage their use of derivatives to hedge business risks. We help our clients with risk management and specialize in accounting for derivatives under US GAAP and International Financial Reporting Standards. Our clients range from the Fortune 10 with thousands of derivatives to the middle market company with a handful of OTC derivatives.

As I may be the last person to testify on the pending OTC derivative reform, I would like to take this opportunity to state that non-financial corporations using OTC derivatives to hedge business risks were not the cause of the recent financial crisis and every consideration should be given to this class of users so that they are not penalized for, in fact, exhibiting prudent risk management by using OTC derivatives. Our clients *do not* use OTC derivatives to speculate, but to lower their risk exposures to interest rates, foreign exchange and fluctuations in price across a variety of agricultural, metals and energy commodities. These businesses need the OTC derivatives market in order to hedge specific cash flows and risks and typically use very basic swaps and forwards as instruments.

The following are examples of how businesses use OTC derivatives for hedging, not for speculative gains:

- A retailer hedges the sale of its handbags in Japan by selling Japanese yen forward.
- A manufacturer hedges the risk of rising interest expense on its floating rate bank loan by swapping to a fixed rate coupon.
- A coffee company hedges the cost to procure milk for the lattes it sells to consumers.
- A beer company hedges the corn by-product as corn prices rise during an ethanol run-up.

I have divided my testimony in three areas regarding the OTC derivatives reform:

A. Key concerns that end-users have as they face pending reform
B. Clarifications on the perceived benefits to end-users
C. Potential solutions to address key concerns for a successful implementation of the reform

A. Key concerns that end-users have as they face pending reform

While a majority of our clients understand the need for better regulation of the OTC derivatives market, there are three areas of concern for corporate end-users of derivatives:

1. **The potential impact of the standardization of OTC derivative contracts.** Currently, OTC derivative contracts can be tailored to uniquely offset a company's business risk. Standardization of these OTC derivative contracts could result in mismatches between the terms of the OTC derivative and the specific terms of the business risk, resulting in improper hedging. In addition to overall poorer performance in achieving their hedge objectives, standardization may result in failing some of the hedge effectiveness testing requirements around derivative accounting under US GAAP, called FAS 133, which as a result of disqualification would lead to additional P&L volatility.

2. **Higher costs to hedge.** There is a concern that the pending legislation will result in fewer Swap Dealers and, therefore, less competition as smaller Swap Dealers and foreign Swap Dealers may find the regulations too onerous. Furthermore, additional capital and margining requirements for Swap Dealers will ultimately be passed on to the end-user, resulting in a higher cost to enter into OTC derivatives. Also, clearing firms may not see the opportunity to clear customized OTC derivatives, resulting in less liquidity and, therefore, wider bid offers.

3. **Margin requirements are costly to provide as well as to maintain.** Of course in any environment, businesses would rather use their cash for other means than posting margin, but even more so today. Companies without the liquidity to post cash margin would have to raise the cash, which would impact their balance sheets and potentially their credit ratings. The liquidity of companies with cash on hand would be impacted as most companies invest in highly liquid securities that could be sold at any time instead of being tied up in a margin account. Furthermore, the cost to manage the daily posting of collateral would be new in terms of systems and people.

   Some of the legislation to date has indeed exempted non-Swap Dealers and non-Major Swap Participants from having to clear their OTC derivatives and to post capital or margin against un-cleared trades. However, it is our concern that if Swap Dealers will be required to post capital and margin against all un-cleared transactions, then ultimately the Swap Dealers may in turn require their end-user clients to post margin to them. In such a scenario, the unintended consequence would be that end-users would have to post cash collateral to Swap Dealers instead of derivative clearing organizations, which would drive up costs.

B. Clarifications on the perceived benefits to end-users

At this point, I would like to highlight some of the reasons why end-users do not see the same benefits that would be expected from standardization, clearing and margining.

1. **End-users are less concerned about credit risk to Swap Dealers:** Most companies do not engage in OTC derivative transactions with Swap Dealers that do not lend them money. So for the most part, corporate end-users will be "net borrowers" to the Swap Dealers. It would be unlikely that a Swap Dealer would ever owe the corporate end-user in the event of a default when including netting for all borrowings and derivatives.

2. **End-users feel they have sufficient price discovery and efficiency without clearing**: Most end-users will call a minimum of three Swap Dealers before executing their OTC derivative transaction, and, for a majority of basic instruments, the pricing is very tight and efficient. The cost of posting margin or the benefit of clearing the trade does not outweigh the current transparency they are able to achieve. The creation of trade repositories as currently proposed would of course be a welcome benefit to end-users for even better transparency.

3. **Standardized derivative products that exist today demonstrate why most end-users do not see the benefits of transparency or reduced credit risk through clearing**: Corporates today have the flexibility to use many exchange-traded futures contracts to hedge; however, for the reasons mentioned earlier, they need the customization that futures contracts cannot provide, and they can enter into the custom hedge without posting initial and variation margin that futures contracts require. Also, for many companies, the futures do not result in the desired settlement, whereby financial futures are typically cash settled when companies would want the hedge to continue. For example, the Chicago Board of Trade Five Year Swap future settles for cash on expiry whereby a corporate end-user would actually want the five year swap to begin and continue for the next five years.

C: Potential solutions to address key concerns for a successful implementation of the reform

With the previous points in mind, I would like to make the following suggestions, which will benefit the end-users of OTC derivatives and help in the long-term success of implementing the reform.

1. **Define exemptions from margin and additional capital requirements for the portion of the Swap Dealer's portfolio sold to end users.** Some of the proposals to date include exemption of clearing and margining for entities that are not a Swap Dealer or Major Market Participant. As mentioned before, there could be unintended consequences where Swap Dealers would be driven to require collateral from their end-users despite the exemption under the reform. In order to avoid this, Swaps sold to end-users by the Swap Dealers should also be exempted from posting margin and, if possible, additional capital for un-cleared trades.

2. **Create a specific definition for Swap End-Users.** Much of the language to date has centered on defining Swap Dealers and Major Swap Participants, which makes sense given that these two classes of users probably use 90.2%[1] of the $604 trillion dollar swap market[2]. Rather than simply define a new class that uses OTC derivatives to hedge, most of the language that would allow for any exemptions from clearing or margin or other definitions resort to defining when the entity is "not" a Swap Dealer or Major Market Participant. As a result, there has been concern that this approach is too broad and could leave open the opportunity for spurious behavior to take advantage of any exemptions within the reform.

   The concerns of attempting to use a broad approach to describe everyone *but* Swap Dealers and Major Market Participants is that some of the proposed definitions and exemptions become less clear, and there is a general concern that it may be easier to create legislation without any end-user exemption if it becomes too tenuous to use terms like risk management and hedging under US GAAP.

   So if there is a need to narrow the scope, then one approach would be by defining the term "Swap End-User". One clear distinction is that corporate end-users do not get compensated for speculation and, not by coincidence, do not exhibit behavior that would take on leverage or large net positions because there is no benefit. In fact, they could lose their jobs if they were to speculate. Companies that hedge have risk management policies that clearly state they do not use OTC derivatives to speculate and also are required to define their hedging strategies as well as their approach to handling US GAAP for derivative use. This policy document could be used as one of the cornerstones to define a Swap End-User.

3. **Exemption for certain OTC derivative transactions less than 12 months in maturity.** Perhaps, with the exception of event-driven instruments like Credit Default Swaps and OTC derivatives with notional principal exchanges, Swaps under 12 months in maturity could be exempt since they typically would not impose real systemic risk and their future potential risk is also lower than longer-dated Swaps. I hope the Committee will not only include the exemption of foreign exchange swaps and foreign exchange forwards included in other proposals but would also consider exemption for single currency interest rate swaps and commodity swaps less than 12 months.

4. **Consider a phased-in approach.** The effort to implement the final legislation will be very challenging given the size of the market, the different agencies and regulators involved and the many different entities using OTC derivatives globally. Consider starting with the Security-Based Swaps that create greater potential systemic risks and plan a gradual phased-in approach for

[1] Estimated from Bank for International Settlements (BIS) end-June 2009 Statistics, not including credit default swap ($36 trillion notional) or commodity data ($3.7 trillion notional)

[2] The total outstanding notional of over-the-counter (OTC) derivatives contracts according to statistics released by the Bank for International Settlements (BIS) at end-June 2009

interest rates, foreign exchange and commodity transactions. If not by instrument type, then additional time to comply should be allowed for the end-user.

Finally, I would like to reiterate and clarify that our clients understand the need for regulation of the OTC derivatives market. Their concern is primarily with retaining their ability to use customized derivatives and with avoiding any new costs associated with the transaction of these valuable instruments, which would make continued use prohibitive. Our clients feel that, given their relatively limited and simple use of derivatives, the current legislative proposals to have regulated trade repositories would alleviate the systemic risks, provide much better transparency and address the business conduct issues that are being addressed in the reform proposals.

Despite some of the negative perceptions around OTC derivatives, corporate end-users of OTC derivatives are able to lower costs of capital and increase profit margins, which is beneficial not only to shareholders but also to consumers, who otherwise would have increased, un-hedged costs and risks passed on to them instead of the risks being intermediated to the Swap Dealers by end-users.

I look forward to addressing any questions from the Committee, and thank you again for the honor of allowing me to share my thoughts and ideas with you.