

Testimony of Don Thompson
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on behalf of the Securities Industry and Financial Markets Association (SIFMA)
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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, my name is Don Thompson, and I am a Managing Director and Associate General Counsel at JPMorgan Chase & Co. I provide legal advice with respect to the full range of JPMC's over-the-counter (OTC) derivatives businesses. Thank you for inviting me to testify at today's hearing.

Benefits of OTC Derivatives to Our Economy

For the past 30 years, American companies have used OTC derivatives to manage interest rate, currency, and commodity risk. Beginning in the early 1970s, global economic forces began to affect American companies, regardless of business type or scope of operations, and two key events are especially noteworthy:

- (1) the United States dropped the gold standard in 1971, which led to floating exchange rates;
- (2) severe oil price shocks led to increased volatility in commodity prices and interest rates.

These events presented complex financial risk management challenges that, left unmanaged, would have negatively affected many companies' financial performance and possibly even their viability. In response to marketplace demand, financial products, such as futures contracts and OTC derivatives, were developed to provide companies with tailored and flexible risk management tools.

Since their inception, OTC derivatives have been used by companies that are exposed to risks in the course of their day-to-day operations that they are unable to manage themselves. As a result, interest rate, currency and commodities derivatives became important and commonplace tools for these companies in 1980s and 1990s. Credit derivatives were developed over the past 10-12 years and – when used responsibly – have served a similar, useful role in managing credit risk. Since then, OTC derivatives have become a vital part of our economy. According to the most recent data, 92% of the largest American companies and over 50% of mid-sized companies use OTC products to hedge risk.

The role of entities like J.P. Morgan in the OTC derivatives market is to act as financial intermediaries. In much the same way that financial institutions act as a go-between with investors seeking returns and borrowers seeking capital in the capital markets, we work with companies and other end-users looking to manage their risk with entities looking to take on those risks.

In this role, we work with many American and global companies and help them manage their risks. Recently, many of our clients have expressed great concern on the affects of the proposed legislative and regulatory changes on their businesses. Clients such as Chesapeake,

Constellation, Medtronic and Cargill are very worried about the unintended consequences of these policy proposals, particularly at a time when our economy remains fragile. In our view, the effect of forcing such companies to face an exchange or a clearinghouse would limit their ability to manage the risks they incur in operating their business and have negative financial consequences for them via increased collateral and margin posting. These unintended repercussions have the potential to harm an economic recovery. We welcome the opportunity to discuss these issues today.

Let me first discuss in detail some of the benefits of OTC derivatives.

(1) Tailored Risk Management

Companies today demand customized solutions for risk management, and the OTC market provides them.

Interest rates

As an example, a typical OTC derivative transaction might involve a company that is borrowing in the loan market at a floating interest rate. This product is similar to a variable rate home mortgage. To protect themselves against the risk that interest rate will rise, the company will enter into an interest rate swap. These swaps generally enable the company to pay an amount tied to a fixed interest rate, and the financial institution will pay an amount tied to the floating rate of the loan. Similar to the homeowner in a variable rate mortgage, if rates rise steeply, they have some protection. Every aspect of the swap can be tailored to the company's needs to ensure that the company is able to match its risks exactly. It is that customization that makes OTC derivatives so useful to companies.

Currencies and commodities

OTC transactions are used in a similar manner by a wide variety of companies seeking to manage volatile commodity prices and foreign exchange fluctuations.

For example, a company may be importing raw materials into the United States to manufacture a product that is sold all around the world – such as aircraft. That American company will want to protect themselves and their shareholders from bearing undue risk if the price of the dollar fluctuates against the currencies it uses to buy raw materials. With no change to its business model, it could find itself in a situation where the price to produce the planes is higher than the profit it makes from selling those planes, simply due to exchange fluctuations outside its control. It could also find itself exposed to changing prices in commodity raw materials, such as steel or fuel. Any responsible company would act to prevent putting itself in this kind of jeopardy and its employees, clients and shareholders at great risk.

In this example, the aircraft company will purchase a currency derivative in the OTC foreign exchange market that allows it to lock in the exchange rate for each of the currencies that it is exposed to. The company would also likely purchase a commodity derivative that will lock in the price of the raw materials. These transactions allow the aircraft company to focus on its core competency -- building planes -- rather than fearing foreign exchange or commodity price risk.

It is important to note that although interest rate and currency derivatives currently are offered on US exchanges, few corporations use these exchange-traded contracts for two main reasons:

- Exchange-traded products are, by necessity, highly standardized and not customized. As a result, companies are unable to match their unique risks to the products that are offered on exchanges; and
- Exchange/clearinghouse collateral requirements are onerous. Clearinghouses (including those that support exchanges) require that participants pledge only liquid collateral, such as cash or short-term government securities, to support their positions in the market without regard to the credit quality of the company. However, companies need their most liquid assets for their working capital and investment purposes. Requiring a company to post cash as collateral means taking that cash out of the company's core business, which hurts the company and its employees.

(2) Collateral

In addition to customization, the other main benefit of OTC derivatives is flexibility with respect to its ability to provide collateral to support its derivative transaction. In the interest rate swap example, the financial institution may ask the company to provide credit support to mitigate the credit risk that it faces in entering into this transaction. Most often, that credit support comes in the same form as the collateral provided for the loan agreement. Thus, if the loan agreement is secured by property, fixtures and/or receivables, that same collateral would also be used to secure the interest rate swap. As a result, the company does not have to incur additional costs in obtaining and administering credit support for the interest rate swap.

The flexibility of the credit support arrangement provided by OTC products is best highlighted by contrasting it to the posting requirements the company would have faced had it executed its interest rate swap transaction on an exchange. The CME Group and its predecessor institutions pioneered risk management products and currently trade a wide variety of interest rate futures and options contracts, including interest rate swap futures, and all companies are free to enter into these contracts. (In fact, JPMC is one of the biggest users of these exchange-traded risk management contracts). However, the exchange requires a high degree of standardization in the contracts it trades, and requires that transacting entities post cash or cash-equivalent collateral to support their trades. In addition, collateral calls may be made up to twice daily, to account for market fluctuations. This requirement of readily marketable collateral is necessary to ensure the clearinghouse is protected from risk; the clearinghouse or clearing member must instantaneously apply that collateral in the event of a participant default.

A clearinghouse is a very highly collateralized central counterparty that becomes the buyer to every seller and the seller to every buyer. In order for the clearinghouse to perform its credit risk mitigating role in the financial system, it is essential for the clearinghouse to be able to calculate accurately how much collateral it needs from a participant to secure the transactions on which it faces that participant. This can only be done for derivatives that are sufficiently standardized and liquid to enable the clearinghouse to obtain prices quickly so that it can calculate how much collateral is needed. This cannot be done with illiquid or non-standard transactions.

Thus, in the example above, if the company had executed its hedge on the exchange, it would have had to post cash or readily marketable collateral upfront and up to twice daily thereafter. By entering into the transaction in the OTC market, the company is able to use the same collateral that it already posted to secure its loan, with no additional liquidity demands or administrative burdens. This collateral is high quality, being the basis for the extension of credit in the loan agreement, but posting it does not affect the company's operations or liquidity. This flexibility to use various forms of credit support significantly benefits companies.

(3) Basis Risk

Another benefit to companies is that unlike exchange-traded derivatives, OTC derivatives match very closely the actual risks that companies need to manage. Without this fit, companies are exposed to so-called "basis risk" -- that is, the difference between the risk that is incurred and the benefit of the hedge. To the extent that there is misalignment of the risk and the hedge, companies will bear the risk of the difference, which could be significant, depending upon the volatility of prices and the level of standardization of the hedge. In fact, the precision of the "fit" determines whether companies qualify for hedge accounting, delineated in FAS 133, which has been developed to address the accounting for hedging transactions. Because of the tailored solutions available through the OTC market, using OTC derivatives is the easiest and most effective way for companies to achieve hedge accounting. Without hedge accounting, companies will see significant volatility in their financial reporting, obscuring the true value of their business.

While we believe that exchanges play an invaluable role, not all entities can or want to trade on exchange. Currently, end-users have the choice of entering into their hedging transactions on an exchange or in the OTC market. For most end-users, OTC derivatives are critical to their risk management, and risk management is critical to their operations in volatile times. We believe that end-users should continue to be allowed to have the choice to use these products.

Problems with use of OTC Derivatives

The discussion of the benefits of OTC derivatives is not to deny that there have been problems with their use, and it is essential that policymakers examine the causes of the financial crisis to ensure it is never repeated. While JPMC does not believe that OTC derivatives were the cause of the financial crisis, it is clear that AIG's near-failure and the consequent investment by US taxpayers involved a subset of credit default swaps as well as poor risk management by its counterparties. In addition, the regulatory framework did not subject AIG to a thorough, comprehensive review--the kind of regulatory oversight to which a national or state bank's derivatives activities are currently subject.

Despite the failures at AIG, it is critical to point out that the markets in these products have continued to be available for end-users, and defaults have been processed as the market infrastructure envisioned.¹ Nonetheless, we believe there is an urgent need for reform to

¹ For example, Lehman Brothers had a portfolio of OTC interest rate derivatives transactions that had an aggregate notional value of \$9 trillion and that was cleared through LCH Clearnet, a clearinghouse that clears the majority of OTC interest rate swap transactions entered into between financial intermediaries. Upon Lehman's bankruptcy, the

address systemic risks that have been revealed by the financial crisis and that reform should encompass OTC derivatives.

Proposals

JPMC believes it is imperative that the root causes of the financial crisis be addressed and that regulatory reform address systemic risk while preserving the benefits of OTC derivatives for end-users. To that end, we propose the following:

- **Financial regulation should be considered on the basis of function not form.** That is, the appropriate regulatory framework should be determined on the basis of what an entity does rather than what legal entity form it takes.
- **A systemic risk regulator should oversee all systemically significant financial institutions and activities.** We believe it is necessary to establish a systemic risk regulator charged with the responsibility to oversee all systemically significant financial institutions and that this regulator should have the capability to impose capital requirements on these institutions, to oversee their transactions with each other and with their customers, and to impose conditions on those transactions, such as collateral requirements.
- **All standardized OTC derivatives transactions between systemically significant financial institutions or professional intermediaries should be cleared through a regulated clearinghouse.** The standardization requirement is necessary because, as discussed above, only transactions with a degree of standardization are capable of being risk-managed by the clearinghouse and thus be eligible for clearing.
- **Enhanced reporting requirements should apply to all OTC derivatives transactions.** For cleared transactions, the clearinghouse would have data on aggregate trading volumes and positions as well as specific counterparty information. Non-cleared transactions should be reported to a trade repository on a frequent basis, and the repository should publish aggregate market data. The systemic risk regulator as well as market regulators such as the CFTC or SEC should have access to the trade-specific data, and regulators should also have the ability to request more detailed information as required.

Industry Actions

In addition to these proposals for federal legislative action, we believe that financial intermediaries can and should act in concert with regulators to begin to provide a more effective framework for the clearing of OTC derivatives products. Clearing of clearing-eligible

clearinghouse auctioned the portfolio, pursuant to its rules, and eliminated the market risk without having to tap its guaranty fund. In addition, Lehman's bankruptcy triggered settlement of credit default swaps that referenced Lehman. It is estimated that there was up to \$400 billion of such transactions outstanding, in gross notional terms, but at settlement, after netting all positions, the total payments owed were between \$6 and \$8 billion dollars. The calculation and payment process occurred in an orderly manner with no reported problems.

transactions provides additional stability to the American financial system. By way of example, in the interest rate swap market, we clear 70% of new transactions. A significant portion of credit default swaps (CDS) have become standardized over time, and we have worked since 2005 with other financial institutions and the Federal Reserve to establish a central counterparty (CCP) to clear standardized CDS. The ICE Trust clearinghouse launched on March 9th and has begun clearing CDS. We anticipate that a significant majority of dealer-to-dealer CDS trading volume will ultimately be cleared as products are migrated to the clearinghouse. In the commodity derivatives market, we clear a significant amount of our inter-dealer OTC derivatives as well.

CDS Clearing

As the ICE Trust clears more clearing eligible CDS contracts, we anticipate that in the near future the large majority of dealer to dealer clearing eligible CDS contracts will be cleared as a matter of routine. Clearing is a highly transparent process, and anyone with access to the internet can view data free of charge. The data relates to daily volume traded, as well as the price used by the clearinghouse for calculating how much collateral the clearinghouse will require from each dealer. The links to the websites showing that data:

<https://www.theice.com/marketdata/reportcenter/reports.htm?reportId=98>
<http://www.markit.com/information/products/cds/cds-page.html>

Interest Rates Clearing

Currently this market clears using the London-based LCH SwapClear service. For outstanding trades as at the close of 2008, SwapClear clears approximately \$160 trillion in notional, which equates to roughly 50% of inter-dealer swap trades globally.

Commodities Clearing

During the three month period ending in February 2009, OTC commodity derivatives dealers cleared on average approximately 40% of their OTC energy derivatives transactions and 35% of other commodity derivatives (excluding metals and agricultural products). We anticipate these percentages will increase over time.

FX Clearing

Clearing has not been an industry practice because FX/currency OTC contracts tend to have shorter maturities, which generally decreases counterparty risk, and counterparty risk is the primary driver for the development of clearinghouses. However, discussions on this have begun among dealers and regulators.

JPMC is committed to working with Congress, regulators and other industry participants to ensure that an appropriate regulatory framework for derivatives is implemented. I appreciate the opportunity to testify and look forward to your questions.