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BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

October 7, 2009

Good morning Chairman Frank, Ranking Member Bachus and Members of the Committee. It is an honor and great responsibility to participate in this hearing today. Thank you for inviting me to testify regarding the regulation of over-the-counter derivatives.

To begin, it may be helpful to know the role of my firm in the OTC derivatives market. Chatham Financial is the largest independent advisor and service provider to businesses who use derivatives to reduce their interest rate and foreign currency risks. A global firm based in Pennsylvania, Chatham has over 1,000 end-user clients in 45 states – ranging from Fortune 100 companies to very small businesses. Chatham is employee-owned and independent – we do not accept compensation from dealer banks. We help our clients hedge risk, not speculate, and we do not advise on credit default swaps.

Given the events in the financial markets in recent years, we applaud the Administration and Congress for considering appropriate changes to our financial regulatory framework, including the area of derivatives. We believe we should all work to reduce the risk to our financial system should one of our largest banks, insurance companies, hedge funds or any other of our largest institutions fail.

While prudent policy changes are needed to address the problems that gave rise to AIG's failure in credit default swaps and in other areas, policymakers need to be careful to ensure that such policies do not harm the many areas of the OTC market that are functioning well.

OTC derivatives are very important tools for businesses to efficiently and effectively reduce risk. Their use is now accepted for many good reasons and is now common – in fact, 94% of Fortune 500 companies and thousands of small businesses use derivatives to manage business risks.

The main issue at hand is reducing systemic risk. The business end users who use derivatives to hedge do not create systemic risk – rather, they use derivatives to reduce business risks which, in turn, reduces systemic risk. Therefore, especially since business end users only make up 10-15% of the overall OTC market, we believe derivatives regulation should be directed at trading activity between systemically significant institutions.

We are very pleased that Chairman Frank and his staff, Members, and others have developed this draft legislation which recognizes and differentiates business end users from large financial institutions. Specifically, this draft focuses central clearing requirements on large market participants, rather than on business end users. Additionally, it precludes those who use OTC derivatives to prudently manage risk from being subject to higher regulatory thresholds under the definition of major swap participant.

We are grateful for the opportunity to offer our suggestions for how the draft bill could be improved. Following are five recommendations for improvement:

1. Margin – Any requirement for business end users to cash collateralize hedging transactions would create an extraordinary and unnecessary drain on working capital. This draft appropriately recognizes this cash burden by excluding end users from the central clearing requirement (page 29). Similarly, we believe this draft should also recognize this cash burden by excluding end users from any margin requirement (page 61). For trades with business end users, we believe credit terms (e.g., margin, collateral) should be negotiated by the two parties. To illustrate this point, a bank may choose to make a *loan* without collateral if the business is creditworthy, therefore it is reasonable that a *derivative* should be allowed to be offered to a business end user without margin if the business end user is creditworthy.

2. Capital Charges – This draft calls for higher capital charges for non-cleared derivatives. We believe this draft should be clarified so that regulators are instructed to set capital charges based on historic or predicted loss, and not as a penalty to discourage the use of OTC derivatives.

3. Systemic Significance. This draft bill recognizes that systemically significant institutions should be subject to higher standards than those that cannot impose systemic risk. However, as currently written, it is possible that non-systemically significant firms could be subject to the same regulatory burden that applies to large financial institutions. For example, community banks that utilize OTC derivatives to hedge their balance sheet risks and offer risk management products to their borrowers, could be deemed "Swap Dealers"

and be subject to the same reporting, clearing and margining requirements. In addition, with the removal of Bear Stearns, Lehman, Wachovia, and Merrill Lynch from the market, there are now too few OTC derivative counterparties. Removing the burden for smaller, non-systemically significant swap dealers will encourage competition and reduce prices for business end users.

4. Major Swap Participant is largely defined by having a “substantial net position”, a term to be defined by regulators. We believe this term should be defined by legislation. If it is not, we would like to see the intent be clear that this definition should target systemically significant institutions.

5. Exemptive Relief. As we make these historic changes to regulate the OTC derivatives market, we cannot now foresee many of the consequences resulting from this regulation. Therefore, we should grant regulators the authority to provide exemptive relief where they deem necessary.

To conclude, even though we have identified several areas for proposed improvements, we want to be clear that we believe this draft is the most thoughtful proposal for regulation of the OTC derivatives market to date.

Thank you again for the opportunity to testify today. I am happy to address any questions that you may have.