Senate Committee on Agriculture, Nutrition & Forestry

Oversight Hearing: Implementation of Title VII of the Wall Street Reform and Consumer Protection Act

Statement of Jill Harlan, Corporate Risk Manager, Caterpillar, Inc.

March 3, 2011

Good afternoon, Madame Chairwoman and members of the Committee. Thank you very much for the opportunity to be with you today. My name is Jill Harlan and I am the Corporate Risk Manager for Caterpillar Inc. I am also testifying on behalf of the Coalition for Derivatives End-Users ("Coalition"), of which Caterpillar is a member. The Coalition represents thousands of companies across the country that use derivatives to manage their day-to-day business risks.

For more than 85 years, Caterpillar Inc. has been a leader in making sustainable progress possible. With 2010 sales and revenue of $42.6 billion, Caterpillar is the world's leading manufacturer of construction and mining equipment, diesel and natural gas engines, industrial gas turbines and diesel-electric locomotives. The company also is a leading services provider through Caterpillar Financial Services, Caterpillar Remanufacturing Services, Caterpillar Logistics Services and Progress Rail Services. We are headquartered in Peoria, Illinois and have manufacturing facilities, distribution facilities and offices across the United States. We directly employ 47,000 people in the United States, and our dealer network employs an additional 34,000. We successfully compete globally from a significant U.S. production base, with approximately 70% of our sales outside the United States in 2010.

We support this Committee's efforts to ensure that derivatives markets operate efficiently and are well-regulated. However, the prudent use of derivatives by Caterpillar and other end-user companies does not generate instability in the financial markets; regulation, therefore, should be focused on those entities and transactions that played a role in the financial crisis.

Understanding and managing risk is key to successfully operating our business and thousands of others in virtually every sector of the U.S. economy. The best-run companies identify risks associated with external and internal factors and seek to mitigate both. At Caterpillar, for example, we can control internal risk factors linked to the way our factories are designed, and the velocity with which we transform input materials into assembled product. We can't, however, control many external factors like the global price of copper, fluctuation in the value of the Japanese yen, or the movement of interest rates in key economies. We mitigate these risks by hedging our net exposures with derivative contracts after taking advantage of any offsetting positions.

As an example, we sell a large quantity of mining truck replacement parts manufactured in Decatur, Illinois, to our dealers in Australia. We pay the costs associated with the production of Decatur parts in U.S. dollars. When we sell those parts, we receive revenues in Australian dollars. The relative value of the Australian dollar versus the U.S. dollar can significantly impact the economic viability of these types of transactions. To manage the risk, we may enter into a forward contract with a bank counterparty to sell a certain amount of Australian dollars, equal to our net exposure, on a certain date to lock in the current market forward rate. We enter into similar hedging transactions to limit our risk exposure to the cost of key input commodities, like copper, as well as to interest rates.

The market for these types of transactions operates extremely efficiently. Through the use of electronic screens, for example, we have the ability to evaluate pricing from multiple potential counterparties before finalizing our trade. The result is efficient and competitive pricing, as well as the ability to further develop relationships with banks.

It is important to understand that Caterpillar does not use derivatives contracts for speculative purposes. Doing so would bring an element of risk to our business that is unacceptable to our Board of Directors and our stockholders. Caterpillar's derivatives policies are specifically written to ensure we only focus on the management of risks associated with our business operations. In fact, our finance subsidiary is subject to legal prohibitions against using derivatives for speculative purposes. Plainly said, Caterpillar does not use derivatives to speculate.

Caterpillar and our Coalition partners have many concerns about the impact of potential rulemaking on our end-user derivative activities. I'll focus today on four primary areas: (1) the potential impact of margin requirements; (2) uncertainty concerning application on foreign-exchange forwards; (3) the need for clarity concerning the impact of regulations on captive finance affiliates; and, finally, (4) the compressed timeframe for rulemaking.

We appreciate greatly that, in passing the Dodd-Frank Act, Congress recognized the fundamental differences between end-users and other participants in the over-the-counter derivatives market. Accordingly, you established an exemption from mandatory clearing requirements for derivatives end-users in the Dodd-Frank Act; however, in the course of the lengthy debate over financial regulatory reform, the statutory language regarding margin requirements ended up being less than clear. While we think that we have a strong legal argument that regulators do not have the authority to either directly impose margin requirements upon end-users or to require end-user counterparties to collect margin from us, we are very concerned that certain regulatory agencies do not appear to agree. We appreciate the fact that CFTC Chairman Gary Gensler has indicated that the CFTC will not impose margin requirements on non-financial end-users; however, it is important to note that because most end-users enter into hedging derivatives trades with *bank* swap dealers, it is the prudential regulators—and not the CFTC—that will set margin rules for most end-user trades. Moreover, the Federal Reserve recently testified that it believes it is *required* to impose some margin requirement on *all* non-cleared trades, *without exception*. Such a position appears contrary to congressional intent and would harm our ability, and the ability of end-user companies generally, to manage our risks.

According to a 2011 Coalition survey, a 3 percent initial margin requirement, assuming no exemptions, would require average collateral of $192 million per respondent. Extending the survey results to all S&P 500 companies, this margin requirement could reduce overall capital spending by as much as $5-7 billion per year, which, according to the survey report, could lead to a loss of 100,000 to 120,000 jobs nationwide. At Caterpillar, we have much more productive potential uses for that capital—such as investing in our production facilities to meet rapidly growing demand for our product. Also, anything that adds to our U.S. cost structure hampers our ability to compete in critical, fast-growing foreign markets. We ask regulators to work together to ensure that margin requirements do not hamper the ability of end-user companies to manage risk through the prudent use of derivatives, and increase our costs to the detriment of investments in core business functions and job creation.

Another area of uncertainty and concern is how and whether the derivative rules will apply to foreign exchange forward contracts. Under the Dodd-Frank Act, the Treasury Secretary is given authority to exempt foreign exchange swaps and forwards from the regulations that will be applied to other derivative contracts. Even if FX swaps and forwards are exempted from the clearing and exchange trading requirements imposed on derivative contracts by the Dodd-Frank Act, all FX swaps and forwards must be reported either to a swap data repository, or if no such repository will accept them, to the CFTC.

We feel that foreign exchange swaps and forwards are very different from other derivative contracts and should be exempted. The FX market is already subject to appropriate oversight by central banks around the world, and it functioned remarkably well during the credit crisis. This market has developed robust risk mitigation practices over the last two decades—including settlement systems and increased bilateral collateralization of exposures—that have successfully mitigated the potential for the market to create systemic risk. We're also concerned that FX swap and forward contract regulation contemplated by Dodd-Frank, if applied to end users, could actually increase systemic risk by introducing significant liquidity risks into the system where none existed, deterring prudent FX hedging and risk management by corporations.

Congress recognized the value that industrial captive finance affiliates bring to the overall economy. During the crisis, organizations like Caterpillar Financial Services brought an additional source of liquidity to small and medium-sized businesses. Accordingly, Title VII of the Dodd-Frank Act includes exemptions from the mandatory clearing requirement and the Major Swap Participant definition for

> …entities whose primary business is providing financing and use derivatives for the purpose of hedging underlying commercial risks related to interest rate and foreign currency exposures, 90 percent or more of which arise from financing that facilitates the purchase or lease of products, 90 percent or more of which are manufactured

> by the parent company or another subsidiary of the parent company.

As you can tell from that direct quote from the statutory language, this is an area in need of greater regulatory clarity. We hope and expect that given the recognized value of Cat Financial and other similar captives, this language, and specifically the "facilitates the purchase or lease of products" provision, will be read broadly.

For example, in order to facilitate the sale of the parent's manufactured goods, captive finance affiliates often finance the sale or lease of products that are intimately connected to the underlying product. Examples include the financing of an implement or accessory to a tractor, the purchase of a used tractor to facilitate the sale of a new one, or the financing of a marine vessel to facilitate the sale of the vessel's engines. In each of these examples, the financing offered by the captive finance unit is essential to facilitating the sale of their parent or affiliate's manufactured goods.

The Coalition also urges that, where no distinction is drawn between non-financial and financial end-users in the Dodd-Frank Act, regulators should not draw one themselves. Both financial and non-financial end-users, for example, should not be subject to margin requirements, provided that they are using swaps to hedge commercial risk, and not for speculative purposes.

A lot is at stake in the regulatory rulemaking process. The current statutory effective date requires regulators to promulgate literally hundreds of rules in a short period of time, creating the risk that speed will take priority over quality. Poorly considered regulation would increase uncertainty and negatively impact companies' ability to manage risks. We would like Congress to provide regulators and affected parties with more time for rulemaking and for regulators to allow market participants sufficient time for implementation. We would note also that implementation flexibility, while desirable, can not overcome a rulemaking process that is hurried, does not allow for sufficient input from affected parties, and could produce ill-conceived regulations as a result.

The end-user market for over-the-counter derivatives functioned well before, during and after the crisis. The responsible and effective use of these products by Caterpillar and other end-users helped reduce risk at both the individual company and at the systemic level. We hope that active oversight from this Committee will help avoid a situation where implementation of rules increases costs for main street businesses and drives behavior that inhibits economic growth.

On behalf of Caterpillar and the Coalition, I'd like to thank you very much for your time this afternoon and the opportunity to share our thoughts on these important issues. I'm happy to answer any questions that you may have.