TESTIMONY OF

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ON BEHALF OF THE

AMERICAN BENEFITS COUNCIL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON COMMODITY EXCHANGES, ENERGY AND CREDIT

HEARING ON CFTC REAUTHORIZATION

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Good afternoon Chairmen Conaway and Scott and Ranking Members Peterson and Scott. I am Lisa Cavallari, Director, Fixed Income Derivatives at Russell Investments. Russell Investments is a global financial services firm that provides consulting, asset management, trading implementation and index services. We provide these services as a fiduciary and an agent of our clients which means that we act exclusively on their behalf. The overwhelming majority of our clients are pension plans or other retirement arrangements that themselves are focused on finding ways to improve their financial security and the long-term financial security of their participants. These clients include many of the major and mid-size US corporations, endowments and foundations, and public retirement systems that drive our economy. Our entire business is built around serving the needs of these clients.

Russell is also a member of the Board of Directors of and works closely with the American Benefits Council (the "Council") whose mission, like ours, is dedicated to the advocacy of employer sponsored benefit plans. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans. We appreciate the Council's years of service and hard work to be an advocate for employer plans and the many thousands of employees who rely on those plans and their employers to help them reach a more secure financial future.

In order to efficiently and effectively help these clients reach their financial goals, Russell trades a variety of instruments through a number of global trading partners and venues. Those instruments include billions of dollars of exchange traded futures and cleared swaps as well as bilateral, uncleared swaps. As a practitioner who trades these instruments for our clients, I am grateful for the opportunity to speak to this subcommittee and share my views about ways that we can collectively continue the good work of Congress and the CFTC to achieve the ambitious goals set forth by the leaders of the G-20 starting in 2009. Derivatives, including both futures and swaps, are an important part of any investment advisor's toolkit and are crucial to achieving many investment goals. Fiduciaries like Russell evaluate them for their appropriateness and often recommend them to achieve client investment objectives.

My trading team is dedicated to facilitating and executing derivatives trading for our clients. It is truly a team effort. We work closely with our colleagues in the documentation, legal, compliance, risk and technology areas to achieve this. Whether it was Mies Van de Rohe or Flaubert who are each alleged to have said "God is in the details," the fact remains that those details have very real consequences. The trading desk often stands at the intersection of many of those details as it pertains to derivatives regulation.

We appreciate the role of the Dodd-Frank Act in adding greater transparency to the marketplace so that investors can make use of available products in a way that allows them to effectively meet their specific investment and risk mitigation goals. We believe the agencies – including the Commodity Futures Trading Commission ("CFTC"), which has jurisdiction over the types of swaps most important to plans, and the prudential regulators -- have worked hard to provide helpful guidance and have been very open to input on the derivatives issues from the pension plan community. We recognize the diligence and enormous effort required of US and other global prudential regulators to bring transparency to an over-the-counter marketplace for bilateral swaps that in terms of dollars notional outstanding is nearly 24x that of the exchange traded futures markets.1

As Russell and other industry participants work to ensure a transition from the rulemaking phase to implementation, we welcome continued open dialogue surrounding these historically unprecedented changes. . In this regard, there are implementation issues affecting the pension plan community that could have very adverse effects on plans and on their ability to mitigate risk.

To further the dialogue, I would like share my views on the following topic areas:

- Background on the primary types of derivatives we trade
- How, why, and the extent to which pension plans use these derivatives
- Factors driving increasing costs and barriers to access for pension plans to use derivatives
- Summary of specific examples of concerns and thoughts on how to address emerging challenges

BACKGROUND ON THE PRIMARY TYPES OF DERIVATIVES WE TRADE

Today the primary three categories of derivatives are (i) Bilateral Swaps, (ii) Futures, and (iii) Cleared Swaps. While these products may appear complicated and it is in part due to that they are questioned, each has a valuable role in the world of investments, particularly for pension plans.

At the time of the Global Financial Crisis, there were only futures and bilateral uncleared swaps. Pension plans frequently used a combination of both. Exchange traded futures are trade standardized contracts executed and cleared with a clearing member under a Futures Commission Merchant (FCM) Agreement. Pensions frequently use futures exposure to gain access to a variety of global equity indices. . Futures contracts have counterparty credit risk with the clearinghouse and the FCM. Collateral

1 Bank for International Settlements *BIS Quarterly Review Dec 2014 and March 2015* http://www.bis.org/publ/qtrpdf/r_qs1503.pdf. Statistical Annex: Detailed Tables 19 and 23A

in the form of both initial margin (different for the risk profile of each product contract) and variation margin (for daily marked-to-market changes) is applicable.

Bilateral swaps, like their name suggests, are traded under specific negotiated documentation with a trading counterparty. Only the two parties involved in the agreement may trade under it. An International Swaps and Derivatives Association (ISDA) Master Agreement is frequently used as the contract that outlines the rights of each party involved with a trade. Bilateral swap exposures, unlike futures, can be tailored to suit a specific need. One example of a trade type is a Russell 2000 total return swap, where a pension plan may want to pay a fee in order to receive the return of the Russell 2000 stock index. Whereas the future trades with quarterly expirations, in set contract amounts and sizes, the bilateral swap can be tailored to have a maturity to match exactly the need of the pension. This flexibility and customization is extremely important for pension plans who have precise asset and liability needs. In contrast to futures, the movement of collateral associated with bilateral swaps is negotiated and is highly dependent upon the credit worthiness of the counterparty because there is no clearinghouse.

After Title VII, there emerged the growing, nascent sphere of cleared swaps. Cleared swaps are like a hybrid between bilateral swaps and futures. The cleared swap is traded under an Addendum to the FCM Agreement. Depending upon the product, the swap may be required to trade on a Swap Execution Facility (SEF). An example of a cleared swap would be a credit derivative index product, called CDX, on US corporate bond names. The product is standardized so it is traded as a swap but cleared on an exchange. Cleared swaps also exist with a distinct and separate collateral regime that is different from futures.

Each of these products, futures, bilateral swaps and cleared swaps have their own unique workflow in terms of documentation and onboarding, trading and execution, confirmations and reconciliation and collateral and resets.

HOW, WHY, AND THE EXTENT TO WHICH PENSION PLANS USE THESE DERIVATIVES

Pension plans use exchange traded futures, cleared swaps and bilateral over-the-counter swaps in a variety of ways. I will limit my comments today to the cleared and bilateral swaps. Pension plans use these derivatives for a range of risk-reducing activities, in part because they are a cost-effective way of obtaining or eliminating specific exposure quickly. An example of risk reduction is the use of interest rate hedging by pension plans. Pension plans have both assets and liabilities (pension obligations to employees) to manage. Interest rate swaps, both cleared and uncleared, are an effective hedge against any potential volatile interest rate movements. If a plan has $5 billion in assets and $5 billion in liabilities, today, everything is balanced. However, if interest rates decline, this impacts the liability side and there will be a

funding shortfall. Depending on the severity of that shortfall, under the worst of circumstances, it could strain the employer's balance sheet and give rise to solvency risk. The more likely scenario though is that it will require the employer to divert resources away from efforts that lead to economic expansion and job creation and into funding the pension shortfall.

This shortfall can be cost-effectively eliminated by employing interest rate swaps. Even in this low interest rate environment we are experiencing today, interest rate swap instruments can meaningfully reduce the volatility of the funded status of a plan. This is a powerful risk mitigant that we need to ensure can continue to be accessible by pension plans. Take for example a pension plan that has hired an investment manager to trade small capitalization stocks. They recently made a strategic decision to decrease the weight allocated to small cap stocks and move into intermediate corporate bonds. It will take a while for them to identify a new manager and transition the physical portfolio. The pension plan could buy derivatives, for example a total return swap that mimics the intermediate corporate bond benchmark index or a combination of interest rate swaps and index credit derivatives. In this way they obtain the desired exposure more quickly, cheaply and efficiently. To be clear, the cost-efficiency of this is a direct benefit to the pension plan participants.

Pension plans are a high quality credit counterparty. In the bilateral world, under ISDA documentation that is negotiated and managed between a pension plan and/or their investment advisor and a swap dealer, the pension is undeniably the stronger counterparty. With exchange traded swaps and futures, initial margin is posted by the client in an amount that is deemed by regulation or by the FCM to be of sufficient amount for a guarantee of contract fulfillment at the time a market position is established.2 For bilateral swaps, the concept of initial margin is referred to as an independent amount. Indeed, the concept of posting collateral in the form of an independent amount for a bilateral swap is almost unheard of for a pension plan. Depending upon how the agreement was negotiated, there may even be unilateral payments. This means that because the pension plan is so creditworthy, that when they owe a swap dealer on a payment, they do not pay the swap dealer, but if the swap dealer owes the pension plan, then the swap dealer makes the payment.

These examples highlight how swaps are used by pension plans often in risk reducing ways. The fact that pension plans are a high quality trading counterparty is also instructive. Keeping these concepts in mind, I move on to the changing (increasing) costs associated with derivatives use and developments that are affecting (negatively) pension plans' access to derivatives. I strongly believe that every pension plan should have a choice between how best to obtain synthetic exposure in a risk disciplined way, whether that be a future, cleared swap or bilateral swap. Pension plans, together with their strategic advisors have a fiduciary duty to thoroughly investigate, research and

2 http://www.cftc.gov/consumerprotection/educationcenter/cftcglossary/glossary_ijk

determine the most appropriate way to obtain their outlined investment objectives. Agents and fiduciaries like Russell can and do help pension plans and others navigate this.

FACTORS DRIVING INCREASING COSTS AND BARRIERS TO ACCESS FOR PENSION PLANS TO USE DERIVATIVES

Costs surrounding cleared and bilateral swaps are both explicit and implicit. Tackling the explicit costs of the new era of cleared swaps, there have been and will continue to be additional costs borne as the result of introduction of this new product to the swaps solar system that previously only consisted of futures and bilateral swaps. As mentioned previously, cleared swaps require their own workflow. Cleared swaps do not replace anything per se, they add something entirely new. These situations surrounding workflows, from trading to collateral movements, directly impact pension plans and/or their investment advisors as well as the swap dealers – in the case of cleared swaps, the Futures Commissions Merchants (FCMs). As of January 31, 2015, the CFTC Financial Data for FCMs report reflects 74 FCMs with just 23 of them supporting cleared swaps.3 There have also been some high profile FCM exits from the cleared swaps business.4 5

At this point I would like to provide a recent, dramatic example of the dynamic of increased costs. A pension plan client of Russell's, one that is active in the futures, cleared swaps and bilateral swaps arenas is facing significant rising costs. Russell is an agent, fiduciary, and investment advisor for the pension plan and trades cleared swaps and futures with one FCM. Their book in gross notional size is a few billion dollars in futures and cleared swaps. On the cleared swaps side, their fees with the FCM had been a per ticket (i.e., one order for $300 million would be one trade ticket) charge of between $250 and $500. If the pension plan traded, assume twice a month a variety of different cleared products, those charges on an annualized basis were equivalent to about $25,000. The FCM citing a number of different regulatory pressures recently presented Russell with a revised fee schedule that represented fees, on an annualized basis, based upon their current portfolio, of $550,000. We've now moved into the fee stratosphere. This is an unwelcome byproduct of this new solar system and one that not only significantly reduces the cost-efficiency of these highly useful and important instruments, but it also may be so cost prohibitive to most clients (particularly midsize or smaller clients) that those clients are priced out of the market. That is a tradeoff

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3 http://www.cftc.gov/ucm/groups/public/@financialdataforfcms/documents/file/fcmdata0115.pdf

4http://www.thetradenews.com/news/Trading__Execution/Industry_issues/EMIR_delay_prompts_BNY_Mellon_clearing_exit.aspx

5 http://finance.yahoo.com/news/rbs-wind-down-swaps-clearing-091729703.html

between certain costs and uncertain (but potentially significant) funding risk that will face all pension clients.

Implicit costs abound everywhere. With new legal definitions, trading venues and addenda to append FCM agreements all attached to derivatives regulation, significant time energy and resources have been spent. Investment Management Agreements (IMAs) have also had to be revised. In 2012, I spent numerous hours explaining to pension plans why they need to register and maintain a LEI (Legal Entity Identifier) and its predecessor the CICI (CFTC Interim Compliant Identifier). Countless hours have also been spent trying to navigate the new world of Special Entities that pension plans invariably became a part of with new regulation. Never has a seemingly innocuous question like "are you a U.S. Person?" been so loaded with meaning, complexity, and work.

There are other more subtle implicit costs for pension plans. With pension plans, advisors and swap dealers all working together to ink new agreements and documents, whereas in the past certain terms or rights were negotiated carefully, that approach was difficult to replicate this time around. The timelines for cleared swaps implementation required that documents be fully executed and "operationalized" well ahead of the start date for each category of derivative end users. Similarly, in very short order, end users were left to discern whether to be a Swap Execution Facility (SEF) member directly or not. All of these examples had the potential to collide in the swaps solar system, and it took an enormous amount of effort to remain in orbit. The degree to which each of these affected a pension plan was largely determined by the instruments that they were using. Based on my own experience and observations, if a pension plan was using futures and bilateral OTC swaps, it was certainly going to use cleared swaps. However, if a pension plan was only using futures and now had the ability (after signing more documentation) to use cleared swaps, they would choose to stick to using just futures. In other words I would have thought there would be more pension plans emerging as new end users of cleared swaps by now, but that has, so far, not been my experience.

There are always growing pains associated with big dramatic change and Russell is cognizant that costs are associated with change. We are also aware of the long-term benefits and value of swaps and respectful of the policy goals of transparent markets. The few points I have mentioned about costs both explicit and implicit are extremely important in the context of having a liquid and well-functioning marketplace. Pension plans and other end users of derivatives benefit from cost efficient ways to obtain their exposures.

Some cost pressures associated with derivative use by pension plans are a direct result of some unintended consequences that are created when considering the implications of different global regulations. This is the last area I would like to mention.

SUMMARY OF A FEW AREAS OF CONCERN AND THOUGHTS ON HOW TO ADDRESS EMERGING CHALLENGES

There are a lot of things in orbit in the new swaps solar system that I have outlined. Pension plans are a high quality credit worthy counterparty in the bilateral OTC swaps construct and play a key role in diversifying customer types for an FCM. FCMs are adapting and changing their own business models. The broad implications of international banking regulations such as Basel III have caused FCMs to re-evaluate the profitability of not just cleared swaps, but futures as well. FCMs are being increasingly more discerning about what products they want to facilitate, under what conditions they will trade and importantly with what type of client they will accept. Though a certain amount of this is healthy and expected, and is the price to pay for transparency, there have been some unintended consequences. Those include (1) increasing fragmentation; (2) reduction in competition as some FCMs exit; (3) increased concentration; (4) increased costs that erode pension or corporate resources; and (5) reduced access as certain client types and sizes are potentially unprofitable for FCMs to face. The combination of these variables creates a situation where pension plans are unable to use risk reducing instruments. Ironically, due to a combination of factors surrounding capital ratios that impact FCMs, pension plans and the type of stable real money accounts they represent are becoming less desirable clients to both swap dealers and FCMs.

Though highly technical in nature, the US implementation of Basel III's Supplemental Leverage Ratio, the Net Stable Funding Ratio, the Liquidity Coverage Ratio, and the risk weights of certain assets are just a few of the calculations that can severely impact the cleared and bilateral swaps pension plans utilize. Where a pension plan is located and what jurisdiction it operates under can also be a key component for determining if a robust legal netting opinion can be obtained from counsel in order to be considered a Qualified Master Netting Agreement under Basel III. The problem some pension plans are at risk of facing, is that if an unqualified legal opinion cannot be obtained, then the swap dealer must account for the pension plan's derivative exposures on a gross basis. This creates a situation where trades by the affected pension plans become either prohibitively expensive to enter, or alternatively, those pension plans are not offered certain products at all. In other words, affected pension plans cannot engage in offsetting risk or reducing risk exposures. This at best significantly increases costs and at worst paradoxically creates a situation where pension plans are less desirable as clients for an FCM or swap dealer. The issue is multi-faceted, but the industry is willing to work with prudential regulators to help remove artificial barriers that only serve to hinder pension plans' use of derivatives.

Another area of concern surrounds the aggregation across affiliates of exposures for the margin of uncleared swaps. It may be worth reiterating the high quality nature of the creditworthiness of pension plans. As it is rare that a pension plan posts an independent amount associated with an uncleared swap today, I believe pension plans

should be exempt from posting in the future. However, under the current proposed rules surrounding the calculations used to determine who should be posting initial margin, it is necessary to aggregate exposures. Interestingly, these proposed rules differ significantly from the Major Swap Participant (MSP) rules already in place. Aligning these rules with the MSP rules already in place could be one possible solution to explore. At Russell, we have a number of different pension plan clients. Those pension plans hire Russell to do very specific things. That same pension plan hires many other investment managers that all have their own unique mandates. The pension plan is the beneficial owner and technically the end user of the derivative. The challenge is trying to assess and roll up all of that derivative exposure. Russell does not have any knowledge of what other managers are doing or what other derivative exposures are present.

Certainly there are other areas of concern. However, various Basel III elements that conspire to make the business less profitable for swap dealers and FCMs also create the unintended consequence of making pension plans appear less desirable as customers. The aggregation issue serves to highlight how some rules are not consistent in their approach and how difficult it is in practice to collect information considering the separate and limited recourse inherent in pension plan structures. To summarize and conclude, I have so far attempted to describe broadly, the use of derivatives by pension plans, some concerns surrounding the increased costs for pension plans that use derivatives and highlight just a few areas of concern. As the new swaps solar system evolves and continues to revolve, Russell is hopeful that certain elements can be fixed along the way to make sure pension plans and other market participants can keep humming along in orbit. We are hopeful that with careful consideration and help the derivatives marketplace will continue to evolve in a way that ensures access and transparency for use by pension plans.