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U.S. House of Representatives
Hearing before the Committee on Agriculture
Defining the Market: Entity and Product Classifications under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act

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Chairman Lucas, Ranking Member Peterson and Members of the Committee, I appreciate the opportunity to testify today regarding the impact of derivatives regulation on community banks, and to add my support for three pieces of legislation under consideration by the Committee. My name is Douglas Williams, and I am the President and Chief Executive Officer of Atlantic Capital Bank ("Atlantic Capital").

Located in Atlanta, GA, Atlantic Capital is a commercial bank with assets of approximately $870 million and deposits of more than $720 million. We focus primarily on serving the banking needs of small to mid-sized enterprises in metropolitan Atlanta and across Georgia. These enterprises are the engine of economic recovery and job creation in our region.

Since opening our doors in 2007 we have provided our customers with the superior levels of service and local market knowledge often associated with smaller community banks while offering access to the banking expertise and capital typically found at larger money center banks. At Atlantic Capital Bank, our bankers have, on average, more than twenty-five years of banking experience.

We take a relationship approach – rather than a transactional approach – to banking. In four short years we have created a better banking experience for over 350 emerging growth companies, small businesses and mid-market enterprises, and we are proud of the relationships we have built with them.

As is the case with hundreds of community and regional banks, Atlantic Capital uses interest rate derivatives to prudently manage risks that are inherent in the business of commercial banking and to help our customers meet their risk management needs. We do not enter into credit default swaps or use derivatives for speculation, trading or proprietary investment. At Atlantic Capital, we use derivatives to hedge the interest rate risk associated with financing we provide to our clients.

Here are three brief examples:

(1) We offered a borrower a competitive construction financing that upon completion converted to a long-term financing. This allowed our customer to meet its objective of locking in its future interest expense on the long-term financing, while also allowing the bank to avoid taking on any incremental interest rate risk. Importantly, we could not have assisted this customer without interest rate swaps.

(2) Atlantic Capital provided financing to a small developer in a low-income area of downtown Atlanta that was leased to a commercial user. Our interest rate swap fixed the rate so that the lease payments exceed the cost of debt in any interest rate environment.

(3) Atlantic Capital financed a Georgia-based exporter of agricultural products and helped them lock in their interest expense with an interest rate swap, allowing them to reduce uncertainty in their business.

Neither our use nor our customers' use of derivatives poses systemic risk. As was shown during the financial crisis, systemic risk in the derivatives market is concentrated among a few very large and interconnected financial institutions. According to the Office of the Comptroller of the Currency's (OCC's) Quarterly Report on Bank Trading and Derivatives Activities, the derivatives market is "dominated by a small group of large financial institutions." While 1,071 banks and trust companies in the U.S. use derivatives, 5 banks hold 96% of the total notional volume and 86% of the total credit exposure. Looking beyond the top 5, just 25 banks hold 99.86% of the total notional volume, and the remaining 1,046 banks together comprise just 0.14% of the entire notional volume held at all U.S. banks.[1]

[1] Please see the attached and refer to page 1 of the report at: http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf

In addition to the vast differences in the size and volume of trades done by small banks as compared to the largest financial institutions, there are important differences in the types of derivatives used by smaller banks and their purposes. Small banks typically use derivatives to hedge their own balance sheet risk or to facilitate the risk management needs of their customers. Small banks generally use interest rate, foreign exchange and, to a lesser extent, commodity derivatives. Use of credit derivatives among small banks is rare. Indeed, only 18 commercial banks in the U.S. currently use the credit default swaps made infamous by AIG Financial Products.[2]

My comments today reflect concern that certain proposed rules released by the Commodity Futures Trading Commission ("CFTC") – including those relating to the key definitions in Title VII - could unnecessarily jeopardize our ability to manage risk, provide the services our clients need and remain competitive against much larger financial institutions. Indeed, this Committee has heard the testimony of representatives from two other community banks, Susquehanna Bank and Webster Bank, regarding the potential consequences of being swept into the "financial entity" - or worse –"swap dealer" definition in Title VII of Dodd-Frank. We share those concerns and strongly support the common-sense legislation recently introduced in the House that seeks to protect smaller banks from the substantial and unnecessary regulatory burden associated with the financial entity and swap dealer classifications. This legislation does not dilute or detract from the important features of Title VII designed to protect against systemic risk and promote transparency in the OTC derivatives market; rather, these bills strengthen the framework established in Title VII.

I would like to focus today on two key issues: the swap dealer definition and the potential exemption from the financial entity definition for small banks.

(1) Swap Dealer Definition

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[2] Based on publicly available call report data on the website of the Federal Deposit Insurance Corporation.

Several community and regional banks have expressed concern that the swap dealer definition in the CFTC's proposed rule could capture hundreds of community and regional banks that offer risk management products to commercial customers. One only need look at the comment file on the CFTC's website for the entity definitions rule to get a sense for the concerns that numerous smaller banks have regarding an overly broad swap dealer definition.[3] A broad definition would hamper the ability for many smaller banks to compete with larger financial institutions without any appreciable benefit in terms of enhanced market oversight or reduction in systemic risk.

Title VII provided an exemption from the swap dealer definition for any swap offered by a bank to a customer in connection with originating a loan with that customer; however, the CFTC's proposed rule interpreting this exemption is unnecessarily narrow. While not required by Title VII, the CFTC is considering whether to limit the exemption to swaps offered "contemporaneously" with origination of the loan. It is important to stress that the word "contemporaneously" is not found in the statute. As it is common for a borrower to enter into an interest rate swap before or after origination of the corresponding loan, the exemption should not be limited to any swap entered into contemporaneously with a loan. In addition, we would urge the CFTC to consider excluding from the swap dealer definition swaps offered by a bank in connection with syndicated loans, loan participations and bond issuances that are facilitated by the bank, as bank customers that benefit from these financings often use derivatives to hedge the associated interest rate risk.[4]

The Small Business Credit Availability Act modifies the swap dealer definition to clarify that swaps offered by a bank in connection with an "extension of credit" that the bank has facilitated should be excluded from the definition of swap dealer. This language is intended to clarify that the CFTC should not take an overly narrow read of the exclusion for these important transactions. This bill will decrease the likelihood that many smaller banks will be forced to choose between limiting the services they offer to customers and complying with the same substantial regulatory burdens imposed on the big Wall Street dealers.

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[3] Please see comment file here: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=933

[4] Please refer to pages 2-3 of the comment letter submitted by Atlantic Capital and 18 other community and regional banks to the CFTC for examples.

Additionally, we are concerned that the CFTC's proposed thresholds for the so-called "*de minimis* exception" from the swap dealer definition are extremely low and should be increased. For example, if a bank were to offer just 21 hedges to customers in one year, it could be subject to the full panoply of regulation applicable to swap dealers, depending on the CFTC's interpretation of the swap dealer definition. Atlantic Capital has been offering interest rate risk management products to our customers for only 18 months, and we currently have 21 swaps with an aggregate notional amount of $88 million on our books. We fear that many small banks, including Atlantic Capital, would simply be forced to cease offering these risk management services to customers to avoid facing the costly regulatory burden associated with registration as a swap dealer.

We urge regulators to compare the thresholds for the *de minimis* exception against the volume of dealing done by the large financial institutions that control the vast majority of the OTC derivatives market. Available data[5] suggest that the CFTC could substantially increase the thresholds without running afoul of congressional intent. For example, at number 1 on the OCC's list of banks with the largest derivatives books, J.P. Morgan has more than $78 trillion in notional volume of active trades in place. The number 10 firm on the OCC's list, PNC Bank, has 0.43% of J.P. Morgan's book, at around $337 billion in notional volume. Assuming that just 10%, or $33 billion, of PNC's total book was done with customers and that these trades were spread over 10 years would give you $3.3 billion per year – 33 times the threshold above which a firm would be deemed a swap dealer under the current *de minimis* threshold of $100 million. Given the relatively infinitesimal level of activity by small financial institutions and the substantial regulatory burden that would be imposed if these institutions were deemed swap dealers, we believe the cost of additional oversight over smaller financial institutions would substantially outweigh any benefits to the financial system.

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[5] Please refer to pages 5-6 of the comment letter submitted by Atlantic Capital and 18 other community and regional banks to the CFTC for additional comparative data: http://www.chathamfinancial.com/wp-content/uploads/2011/02/Coalition-Comments-Small-Banks.pdf

The discussion draft that amends the Commodity Exchange Act to clarify the definition of swap dealer modifies the *de minimis* exception to the swap dealer definition to exempt entities from registering as a swap dealer if the average aggregate gross notional volume of its outstanding swaps over the preceding 12 months does not exceed $3 billion as adjusted by the Consumer Price Index for the 12-month period ending the preceding April 30. The bill's modifications to the swap dealer definition and the inclusion of a specific threshold for the *de minimis* exception would result in the regulatory capture of firms which dominate the derivatives market while alleviating the burden for small banks which collectively comprise a fraction of the derivatives market.

(2) Potential Exemption for Small Banks

Congress provided the regulators with the authority to exempt small banks from the financial entity definition. If such an exemption were granted, these small banks would only be exempt from the clearing and trading requirements if they are hedging commercial risk and report certain information to the regulators.[6] Moreover, small banks already are subject to existing regulations and supervisory guidance aimed at protecting against counterparty credit risks, including rules that require adequate capital to be held against all assets, including derivatives, and that dictate the maximum exposures a bank could take to one customer or counterparty. Furthermore, existing regulations allow examiners to take certain actions to prevent default, or to limit bank losses in the event of default. Atlantic Capital and other small banks employ sound risk management practices to manage our exposures to bank counterparties to a modest level including the use of collateral agreements with these counterparties which require them to post liquid collateral for our benefit as exposure is created. These protections adequately mitigate risks associated with an exception for small banks.

Many community banks are concerned that the clearing and trading requirements attendant to classification as "financial entities" could have the effect of shutting them out of the derivatives market altogether. Initial estimates of clearing costs suggest that a community bank may have to

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[6] Any exempt small financial institution still would have to meet the conditions required for the end-user exception to mandatory clearing and trading.

pay a clearing member – in most cases an affiliate of a large Wall St. bank - over $100,000 per year just to maintain the ability to clear swaps. Additional fees would be charged by the clearinghouses and trading platforms, and legal counsel may be required to negotiate clearing-related documentation.

While large buy-side firms and hedge funds may do enough trading per year to justify these costs, smaller banks may have no choice but to stop using derivatives. If so, these banks would no longer be able to offer customers the risk management products they need and would have a more difficult time managing basic risks that are inherent in banking. These would be unfortunate and entirely avoidable outcomes that would have the effect of weakening the banking system and the economy.

We urge the committee to prevent such outcomes by passing the Small Business Credit Availability Act which would provide a targeted exemption for smaller banks from the financial entity definition. The bill would modify Title VII and provide an explicit exemption from the financial entity definition for small banks, savings associations, credit unions and farm credit system institutions that have $30 billion or less in assets or whose current and potential future exposure for swaps is no greater than $1 billion. It should be noted that this $1 billion exposure threshold is just 1/8th the exposure threshold proposed by the CFTC in its definition for so-called "major swap participants" that have derivatives exposures large enough to pose a threat to the financial system. In addition, the OCC's stats show that the notional amount held at U.S. banks and trust companies with $30 billion or less in assets comprises just 0.09% of the total notional amount held by all U.S. banks and trust companies.

We recognize that it is important to resist legislative changes that run counter to the core objectives of Dodd-Frank by creating loopholes that would permit firms or activities that pose a risk to our financial system to escape regulatory capture; however, neither of these bills would have such an effect. Indeed, the targeted application and careful wording of these bills would strengthen Dodd-Frank by limiting unintended harm to smaller banks. The large dealers and major market players would still be subject to registration, supervision and substantial regulations aimed at reducing systemic risk and promoting transparency in the derivatives market. In addition, any market participant using derivatives for speculating, trading or investing still would be subject to the clearing, trading and margin requirements.

I also wish to show support for H.R. 1840, an extremely important piece of legislation that enhances Title VII for the benefit of all market participants, including small banks. H.R. 1840 requires the CFTC to perform a qualitative and quantitative cost-benefit analysis and to make a reasoned determination that the benefits of new regulatory requirements justify the costs. H.R. 1840 lists specific factors, including available alternatives to regulation, that the CFTC must consider as part of its cost-benefit analysis. We urge the Committee to pass H.R. 1840 and to take steps to ensure that the regulators prioritize quality over expedience in their rulemaking effort.

Conclusion

It is essential that small banks have continued access to interest rate risk management tools to support recovery and job creation at the small and middle-market businesses that form the foundation of the US economy. We applaud the work of the Committee and the regulators to strengthen the OTC derivatives market, but we urge caution against finalizing rules that would place undue burdens on small banks that are incapable of posing future systemic risk and collectively engage in a fraction of the derivatives traded by the large dealers. We urge this Committee to address the specific concerns of small banks by passing the Small Business Credit Availability Act and the bill that would amend the Commodity Exchange Act to clarify the definition of swap dealer.

I thank you for the opportunity to testify today, and I am happy to answer any questions that you may have.