TESTIMONY OF NEIL M. SCHLOSS
VICE PRESIDENT AND TREASURER, FORD MOTOR COMPANY
HOUSE COMMITTEE ON AGRICULTURE
JULY 21, 2011

Chairman Lucas, Ranking Member Peterson, and members of the Committee, Ford Motor Company appreciates the opportunity to share our views on the important role of financial derivatives and their regulation under the Dodd-Frank Act. As you are aware, Ford Motor Company is a global automotive industry leader with about 166,000 employees and about 70 plants worldwide. In the U.S., about 320,000 present and past employees depend on Ford for their pension and retirement. Through our captive finance arm, Ford Motor Credit Company ("Ford Credit"), we also provide financial services to about 3,000 dealers and about 3 million retail consumers in the U.S. alone.

Derivatives are integral to allowing us to manage market risk and help ensure that we can continue to focus on the things that really matter -- manufacturing, selling, and financing vehicles globally. We do not use derivatives to speculate or take a view on the market.

We support Congress' intention in the Dodd-Frank Act to strengthen over-the-counter derivatives regulations, promote transparency and facilitate federal oversight of these critical markets. However, we want to urge that as regulations are being developed, proposed, and implemented, that Congress' clear intent to allow end-users to continue to use derivatives to reduce risk be reflected. We are especially concerned about two potential unintended consequences that could negate Congress' intent and have significant adverse implications for our business - (1) mandatory margin requirement on derivatives that we use solely to hedge legitimate business risks; and (2) limitations on our pension plans' ability to use derivatives to protect our pension obligations to our employees and retirees.

While the recent financial crisis certainly impacted our company, our employees, customers, and dealers, we managed through these difficult economic conditions and our underlying business continues to improve. Despite continued weakness in the economy, we have been able to not only fund our business, but also hedge our risks with derivatives at a cost that is both acceptable and sustainable. Derivatives are a key tool for risk mitigation as Ford continues to work toward improving its balance sheet and financing its plan. In the first quarter of 2011, Ford Motor Company earned a pre-tax operating profit of $2.8 billion and generated $2.2 billion of Automotive operating cash flow. This is after a very good 2010 with $8.3 billion of pre-tax operating profits and $4.4 billion of positive Automotive operating cash flow. Our One Ford plan is working and remains unchanged, focusing on delivering great products, a strong business, and a better world.

BACKGROUND

Ford uses derivatives to manage market risks (i.e., foreign exchange, commodity and interest rate risks) resulting from the design, manufacture, sales and financing of our vehicles. Derivatives are also a key risk mitigation tool for our pension plans as we seek to match the duration of plan assets with the duration of plan liabilities (which at year-end 2010 were $70 billion globally).

As of March 31, 2011, our total automotive manufacturing and financial services derivative notional outstanding was about $75 billion: $62 billion hedging interest rate risk; $11.5 billion hedging foreign exchange risk; and $1.5 billion hedging commodity price risk. The market value of our derivatives was over $800 million and was a receivable to Ford and its subsidiaries – this is the amount the banks would owe us if we needed to terminate the derivatives. A substantial portion of our derivatives (about $68 billion) are hedging exposures from our financial services business.

All of these derivatives are over-the-counter ("OTC") customized derivatives. Only a small fraction of our foreign exchange and commodity derivative trading relationships at Ford require us to post margin. We have no such posting requirements at Ford Credit. Instead, we pay an upfront credit charge commensurate with the risk of the underlying transaction, which is a common industry practice. The credit charges we pay have reduced significantly since the late 2008 financial crisis as market conditions and Ford's credit profile have improved.

The derivative notional within Ford's pension funds is also significant. Our pension funds use both exchange-traded and OTC derivatives. On OTC derivatives, our pension funds post and receive variation margin but do not post or receive initial margin.

Automotive Manufacturing Operations

In our manufacturing operations, Ford uses derivatives to hedge currencies and commodities to lock in some near-term certainty for both revenues and costs from global vehicle production. Without hedging we expose ourselves, our customers and our investors to significant volatility risk. That translates into higher costs, lost sales, and fewer jobs.

We are a capital intensive business with facilities that manufacture vehicles that we sell globally. For example, the Ford Explorer SUVs manufactured in Chicago, Illinois, are not only shipped to various states within the U.S., but are also exported to Canada, Mexico, and many other countries. Currency exposure that arises from Explorer's production costs being in U.S. Dollars and revenues in Canadian Dollars and Mexican Pesos is hedged using foreign currency swaps, forwards, and option contracts. This assures we have more certainty around our vehicle profits.

Similar exposures exist throughout Ford's worldwide operations related to finished vehicles, components, and raw material. We also use over-the-counter derivatives to hedge commodities such as aluminum and copper, while opting for long-term supply arrangements for some commodities that do not have a deep and liquid financial market. Many product and sourcing decisions are made years in advance of delivery.

We execute the majority of our global foreign exchange and all of our commodity swap transactions through a wholly owned hedging subsidiary in the U.S. This centralized entity acts as the primary external-facing counterparty for these transactions. It executes transactions with banks after having compiled a net position representing the sum total of a given day's affiliate transactions. A centralized hedging model not only serves to concentrate expertise, controls, and execution, but it also provides the benefit of being able to net positions across an entire company, which results in more efficient execution thereby lowering the overall cost and counterparty exposure to Ford, and reducing the corporate credit risk we pose to the market.

Financial Services Operations (Ford Credit)

Ford Credit uses derivatives to manage its interest rate and currency exposure resulting from financing sales and leases of vehicles manufactured by Ford. A large majority of Ford Credit's derivatives (about $62 billion of our total $68 billion in derivatives notional) are used to manage its interest rate exposure.

Interest rate risk at Ford Credit results from differences in terms of interest rates on the loans we extend to dealers and consumers versus the rates on the funding we raise in the capital markets. For example in the U.S., we offer our retail customers fixed payments at fixed interest rates. However, much of our funding is driven by investor preferences, which could be floating rate notes and bonds. As a result, we must rely on derivatives to manage this mismatch.

Apart from managing the overall interest rate risk, Ford Credit also uses interest rate derivatives to hedge its asset-backed securitization transactions. Today, over 60% of Ford Credit's interest rate derivatives are being utilized to hedge securitization transactions. Securitization transactions use derivatives to protect investors from market risks and are required to support the triple-A ratings demanded in these markets. As of March 31, 2011, Ford Credit's securitization transactions funded more than 50% of our managed receivables. The securitization and other funding Ford Credit attains from the market enables it to provide financing to the vast majority of Ford's dealers and customers, providing financing to about 3,000 Ford dealers with about 3 million active consumer accounts in the U.S. To the extent our structures are compromised it would likely impact the cost of credit to the small businesses (i.e., Ford dealers) and consumers.

Ford Credit also uses derivatives to hedge currency exposure resulting from accessing the debt and capital markets globally. Cross-border transactions are an essential part of Ford Credit's funding toolkit – providing access to a more diverse group of investors, which reduces our overall borrowing costs.

Pension Plans

Ford Motor Company has about 65,000 active participants and 257,000 retired and deferred participants in the U.S. who depend on Ford's U.S. pension fund for their retirement. Ford's U.S. pension fund uses derivatives to manage risk and mitigate funded status volatility that would be harmful to participants in the pension plans and to the company. For example, one of the biggest risks faced by pension funds is interest-rate risk. In Ford's case, a one percentage point drop in interest rates causes U.S. pension liabilities to increase by $5.6 billion, offset partially by an increase in pension assets. The net impact would be a substantial funding shortfall. For our pension participants, this means their pensions would be less well-funded and potentially less secure. For the company, making up the funding shortfall would mean eliminating new car programs, and the thousands of jobs they would support.

However, this interest-rate risk can be managed by using interest-rate swaps which reduce the volatility of our funding obligations. Ford's pension fund used swaps from 2007 to 2009 to hedge interest-rate risk. As a result, we were able to mitigate the deterioration in our plans' funded status during this critical economic period, saving over seven percentage points of funded status and over $3 billion in contributions.

FORD'S POSITION

As an end-user of derivatives, Ford Motor Company recognizes that well-functioning derivatives markets are important. We fully support legislation to strengthen the OTC derivatives regulations that would promote transparency to facilitate oversight of markets and activities of participants.

We are pleased with Congress' intent to grant exemptions in the Dodd-Frank Act to commercial end-users and their captive finance arms. These end-user exemptions ensure companies like Ford can continue to hedge their manufacturing and financing risks as they do today. As policymakers continue to look for job growth and investment in the U.S. economy, it should be very clear that diverting capital, jobs, and investment away from businesses focused on Main Street is not the kind of unintended consequence the U.S. economy can afford. It is our expectation that the implementation of the Dodd-Frank Act will reflect Congressional intent to clearly distinguish between areas that do and do not present risk to the stability of the U.S. financial markets. It is critical that we avoid any potential unintended consequences that would introduce risk or potentially hinder the economic recovery.

We believe Congressional intent is reflected in U.S. Treasury's proposed rule that foreign exchange swaps and forwards should be excluded from the definition of "swap" in the Dodd-Frank Act and, therefore, be exempt from central clearing and exchange trading requirements. Unlike other derivatives, foreign exchange swaps and forwards are short-term instruments and have been trading in a liquid, efficient, and highly transparent market for many years. We support this proposed rule.

However, we also believe there are couple of areas where Congressional intent is in jeopardy. These most notably include mandatory margin requirements and fiduciary standards imposed on swap dealers that trade with pension plans.

Margin requirements for commercial end-users and their captive finance arms

Our first concern is on the Notices of Proposed Rulemaking ("NPRs") from the prudential regulators and Commodity Futures Trading Commission ("CFTC") related to margin requirements on derivatives that are not cleared through a clearinghouse. As presently written, they would require commercial end-users (Ford) and their captive finance arms (Ford Credit) to post both initial and variation margin.

A margin requirement would not only negate the exemption from the Major Swap Participant definition provided by the Dodd-Frank Act, but it is also contrary to Congressional intent to exempt commercial end-users and their captive finance arms from both clearing and margin requirements. It would also result in a contradiction within the regulations themselves, whereby Ford and Ford Credit are exempt from clearing but then subject to the most onerous margin requirements. Similar to other end-user corporations and manufacturers, we are concerned that imposing margin requirements would significantly increase our cash requirements and costs, and provide a disincentive to hedge legitimate business risks, which would seemingly increase systemic risk.

The unintended consequence of margin requirements on commercial end-users is the increased cost of risk management for U.S. companies. This higher cost potentially puts participants and the broader U.S. market at a competitive disadvantage to its foreign competition. In an already competitive automobile industry, any added required costs are a material issue. We therefore urge the prudential regulators and the CFTC to exempt commercial end-users and their captive finance arms from margin requirements to avoid putting the U.S. market, and the U.S. companies that are dependent on them, at a competitive disadvantage.

Commercial End-Users

Although the regulators note their intent to be consistent with current market practices, the proposed rules require swap dealers to collect initial and variation margin from commercial end-user counterparties.

> Section _.1(2) of the prudential regulators' NPR requires banks to collect margin above an exposure threshold adopted by the banks. Similarly, sections 23.151 and 23.154 of the CFTC NPR require swap dealers to execute credit support arrangements specifying exposure thresholds and margin requirements and require swap dealers to collect margin from non-financial end-users if thresholds were to be exceeded.

We agree that trading derivatives is a credit decision for dealers and that their credit exposure should be appropriately managed. However, posting margin or having a credit support agreement is not a universal practice followed by all market participants today. Swap dealers execute master netting agreements with their end-user counterparties and manage net credit exposure on a portfolio basis rather than managing credit exposure on a transaction-by-transaction basis. In many cases, as an alternative to requiring margin, the dealers buy credit protection to reduce their credit exposure and transfer the cost to the end-user counterparty as credit charges on the transaction.

Mandatory margin requirements would necessitate new and costly incremental funding requirements on end-users. Unlike swap dealers and major swap participants, most end-users do not have expedient and low-cost access to liquidity sources such as the Federal Reserve discount window and FDIC-insured consumer deposits. In our case, raising additional capital requires lead time, is normally done for a longer tenor, and is relatively more expensive. Additionally, given that the nature of our derivative requirements is generally driven by one-sided exposures, we are disadvantaged in being able to manage margin compared to swap dealers, who generally see more trading flow with offsets and have a broader base of counterparties to allow for lower margin requirements. Again, while unintended, the impact would be disproportionately high to manufacturing end-users.

Captive Finance Companies

Another important issue is that the margin rules need to be consistent with the Dodd-Frank Act and Congressional intent to exclude certain captive finance companies from the definition of financial entity, thereby exempting them from clearing and margin requirements.

As evidenced by the following references, both NPRs acknowledge that captive finance companies should be excluded from margin and clearing requirements:

> Footnote 41 in section _.2(1)(b) of the prudential regulators' NPR states that "This definition of “financial end user” is based upon, and substantially similar to, the definition of a “financial entity” that is ineligible to use the end user exemption from the mandatory clearing requirements of sections 723 and 763 of the Dodd-Frank Act."
>
> The CFTC, in its NPR, states that its definition of financial entity “tracks the definition in section 2(h)(7)(C) of the Act that is used in connection with an exception from any applicable clearing mandate.”

Although the goal to be consistent with the Dodd-Frank Act is evident in the NPRs, neither the financial end-user definition in section _.2(1)(b) of the prudential regulators' NPR, nor the financial entity definition in section 23.150 of the CFTC NPR explicitly exclude captive finance companies. Moreover, the definitions of financial end-user and financial entity in the NPRs could be interpreted as categorizing captive finance companies of commercial end-users as a "high risk financial end-user" because they are not subject to capital requirements established by a prudential regulator or state insurance regulator. This subjects them to the strictest margin requirements. Clearly, this would be very problematic for us.

Our key concern related to margin requirements for Ford's captive finance arm, Ford Credit, is the potential disruption in accessing the asset-backed securitization markets. Mandating a margin requirement for securitization derivatives will force major structural changes to many of our programs and result in substantial additional cost as well as legal and administrative complexity. Consistent with present market practice, Ford Credit's securitization transactions are not structured to post margin. An initial margin could theoretically be posted by diverting some of the proceeds from the issuance of the transaction, which would reduce the funding received from the issuance, lowering transaction efficiency and increasing cost. Variation margin is even more problematic as our bankruptcy remote structures do not presently have a mechanism allowing them to post cash collateral on an ongoing basis, and we are unaware of any structure in the market that has such a feature. Alternate hedging solutions that do not require margin would be very expensive and, as a result, would reduce liquidity for Ford Credit.

Going forward, these provisions could prevent Ford Credit and many other end-users that use securitization from efficiently accessing these markets or from having the backstop liquidity that is so important for an economic downturn. (Ford Credit has over $30 billion of committed funding credit lines from banks and their conduits.) Limiting investor demand or bank support for Ford Credit would directly impact the amount of financing that could be made available to our dealers and customers.

During the recent credit crisis, when many financial institutions were curtailing credit availability, Ford Credit continued to consistently support Ford's dealers and customers, now providing financing to about 3,000 dealers with a portfolio of about 3 million retail customers. Unlike other asset classes in the securitization markets, auto ABS is back to pre-crisis market liquidity levels with borrowing spreads that are nearly back to pre-crisis levels. Another disruption to the auto securitization markets is something neither the U.S. economy nor our industry can withstand while trying to recover and add jobs.

Throughout the process of drafting, passing, and implementing the Dodd-Frank Act, Congress has repeatedly expressed its intent to exempt commercial end-users, including certain captive finance companies from margin requirements. This is evident not only in the Dodd-Frank Act but also in records of Congressional proceedings, colloquies, and letters. The most recent of these is a particularly helpful letter dated June 20, 2011, submitted by Chairman Lucas and Chairman Stabenow to the prudential regulators and CFTC in response to the proposed margin rules.

This letter not only asks for clarification that certain captive finance affiliates of manufacturing companies *("whose primary business is providing financing, and uses 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"*) be classified as non-financial (or commercial) end-users, but also expresses concern that the proposed margin rules undermine the exemption granted by the Dodd-Frank Act to the commercial end-users.

Recommendation

Since Ford's last testimony on derivatives before the Senate Agriculture Committee in late 2009, we certainly appreciate that the Dodd-Frank Act specifically recognized the low-risk nature of how derivatives are used by commercial end-users and their captive finance arms. Ford strongly commends this Committee and Congress for this. We also ask that you continue to urge regulators to match their rulemaking to Congress' clear intent expressed in the Dodd-Frank Act and numerous other ways. Specifically, we would recommend the following related to margin requirements on derivatives that are not cleared through a clearinghouse to implement section 4s(e) of the Commodity Exchange Act ("CEA"), as amended by section 731 of the Dodd-Frank Act:

- Captive finance companies and their securitization entities as described in the CEA section 2(h)(7)(C)(iii) as amended by section 723 of the Dodd-Frank Act that are excluded from financial entity definition in the CEA section 2(h)(7)(C) and therefore exempt from clearing requirements per CEA section 2(h)(7)(A) should also be excluded from prudential regulators' and CFTC's definition of financial end-user and financial entity, respectively, and therefore be exempt from margin requirements.
- Commercial (or non-financial) end-users who are exempt from clearing requirements per CEA section 2(h)(7)(A) as amended by section 723 of the Dodd-Frank Act should not be required to post margin on their un-cleared derivative transactions with swap dealers.
- End-user affiliates of commercial end-users including centralized hedging entities wholly owned by commercial end-users who are exempt from clearing requirements per CEA section 2(h)(7)(A) as amended by section 723 of the Dodd-Frank Act should also be exempt from clearing and margin requirements.
- Consistent with Treasury's proposed determination, all foreign exchange swaps and forwards should be excluded from the definition of "Swaps" in section 721 of the Dodd-Frank Act and therefore be exempt from clearing and margin requirements.

<u>Business conduct requirements for swap dealers trading derivatives with pension plans</u>

Our second major issue is regarding derivatives used by pension plans, specifically the business conduct standards for swap dealers and major swap participants ("MSPs"). As part of the Dodd-Frank Act, Congress adopted the business conduct standards to ensure that swap dealers and MSPs deal fairly with pension plans. However, the proposed regulations issued by the CFTC could actually have serious adverse effects on pension plans.

Pension plans use swaps to manage interest-rate risk and other risks, in order to reduce volatility with respect to funding obligations. If swaps were to become materially less available to pension plans, plan costs and funding volatility would rise sharply. We are very concerned that an inadvertent disconnect in proposed regulations between the Department of Labor ("DOL") and the CFTC business conduct standards, as well as other issues in the business conduct standards, may have several unintended consequences resulting in counterparties being unwilling to trade with pension plans.

The proposed CFTC business conduct standards require swap dealers and MSPs that enter into swaps with pension plans to provide certain services (for example, provide information regarding the risks of entering into a swap, provide valuation services, and review whether the plan's advisor is qualified to advise the plan with respect to the swap). These required services could make the swap dealer a plan fiduciary under DOL regulations. If a swap dealer or MSP is a plan fiduciary, it would be a prohibited transaction under ERISA for the swap dealer or MSP to enter into a swap with the plan; swaps dealers would thus be precluded from entering into swap transactions with pension plans.

In addition, the proposed business conduct standards define so broadly the terms under which a swap dealer is an "advisor" that swap dealers would effectively function as advisors to plans, triggering a duty to act in the best interests of the plan. This creates a conflict of interest that would also, pending further clarification, prevent dealers from entering into swaps with a plan.

Finally, the business conduct standards require the swap dealer to review the qualifications of the plan's advisor, which would give the dealers the right to veto plan advisors. Congressional intent underlying the business conduct standards was to protect entities such as pension plans. However, if swap dealers or MSPs can veto plan advisors, concerns about being vetoed by dealers could make plan advisors more reluctant to negotiate in a zealous manner with dealers, and less inclined to vigorously defend the plan's best interests by challenging dealers.

If Ford's U.S. pension fund is unable to use swaps to manage its interest-rate risk, its pension fund participants would be affected, and the company's own balance sheet risk profile and potential cash contributions could increase significantly because of increased volatility. Concern about the uncertainties regarding cash contributions in any given year would cause Ford to hold large contingency reserves of cash. This is money that would not be available for investment in research and development, new car programs, and jobs.

Such an outcome would also put us and other American end-user manufacturers with defined benefit plans at an enormous competitive disadvantage to foreign competitors who do not have large defined benefit pension plans. This increased volatility and its enormous potential cost would be solely focused on those American end-users who are seeking to offer company sponsored and funded retirement security to their retirees and workers.

Recommendation
Ford strongly recommends that Congress continue to urge regulators to coordinate efforts in areas where their regulations overlap and to address other issues in their regulations; so that pension plans are not inadvertently precluded from using derivatives that help them manage risk on behalf of the pension plans' beneficiaries.

We and other large defined benefit plan sponsors have been working with industry groups, including the Committee on Investment of Employee Benefit Assets ("CIEBA") and American Benefits Council ("ABC") on the issues affecting pension plans. CIEBA and ABC have provided a number of comment letters and proposed solutions addressing these issues. Among their proposals to the DOL and CFTC are:

1. Preferred solution -- that the CFTC Business Conduct Standards NOT be applied to swaps transacted with pension plans, or as an,
2. Alternate Solution – (i) clarification by the DOL and CFTC that no action of a swap dealer that is required solely by reason of the CFTC Business Standards will result in the swap dealer becoming a fiduciary, (ii) statement by the CFTC that a swap dealer will not be considered as an advisor if it explicitly states that it is acting only as a counterparty, and (iii) removal or limitation of the CFTC dealer requirement to approve the plan's advisor.

We support these proposals, and urge the regulators to take these recommendations into consideration as they finalize their regulations.

CLOSING

We appreciate Congress' and this Committee's recognition that margin requirements should not apply to end-users such as Ford and Ford Credit that only use derivatives to manage legitimate business risks. Our concern focuses on two areas of proposed regulations, which, if not addressed, could have major unintended adverse ramifications for our business. We thank you for the opportunity to share our concerns. In summary, we are focused on primarily two issues as derivative regulations become finalized:

> Commercial end-users and their captive finance arms including their securitization entities should be exempt from margin requirements on their un-cleared derivatives – Congressional intent is evident in the Dodd-Frank Act, records of Congressional proceedings, colloquies, and letters.
>
> Coordinated efforts by the CFTC and DOL to ensure that pension plans are not inadvertently precluded from using derivatives that help companies protect pension plan beneficiaries and manage their own balance sheet risk.

We thank the Committee for maintaining this dialogue - through the Chairman's recent letter and your invitation to appear here today - and for giving derivatives market reforms the serious attention they deserves. We are happy to continue to provide our support in whatever way possible and answer any questions the Committee may have.

NEIL M. SCHLOSS

Vice President - Treasurer, Ford Motor Company

Neil M. Schloss is Vice President – Treasurer for Ford Motor Company, a position to which he was elected on March 29, 2007.

Mr. Schloss joined Ford Motor Company in 1982 as a financial analyst in the Controller's Office at Ford Aerospace. From there, he progressed through a series of finance positions at Aerospace before transferring to Ford in 1990. In 1991, he joined the Treasurer's Office at Ford Credit and held positions in both Risk Management and International Financing. In 1995, he returned to Ford Motor as Manager, Domestic Financing, followed by the position of Manager, International Financing. In 1997, he returned to Ford Credit's Treasurer's Office as Manager, North American and European Financing. In 1998, he was named Assistant Treasurer, Ford Credit, responsible for Debt Issuance, Capital Planning, and Affiliate Financing. He maintained that position until December 1999. In January 2000, he was named Director, Financial Strategy, Treasurer's Office, Ford Motor Company. In December 2002, he assumed the role of Director, Global Risk Management, Treasurer's Office, Ford Motor Company. On April 1, 2003, Neil was promoted to Assistant Treasurer, Ford Motor Company.

Prior to joining Ford, Mr. Schloss earned an undergraduate degree in Finance from San Diego State University and a Masters of Business Administration from the University of Santa Clara.