Commodity Futures Trading Commission
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Remarks

Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Consumer Federation of America Financial Services Conference

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Good afternoon. It is a pleasure to be with you today. I'd like to thank the Consumer Federation of America for inviting me to speak today and for all the work CFA does to protect consumer and investor interests in America. I recall working hand-in-hand with this organization on consumer privacy in the 90s and again with you to protect investors with the Sarbanes-Oxley Act. Today I'd like to speak to you on the need for comprehensive reform of over-the-counter (OTC) derivative markets.

Last year's crisis marked a defining moment in our nation's history. We have all witnessed firsthand the effects that it had across the entire economy. Everybody in this room put money into a single company that was so interconnected with other financial institutions that its failure threatened the entire system. $180 billion of taxpayer money went into AIG. That's about $600 from each person in this room or nearly $414 million per Congressional district. The crisis was a call to action to ensure that we do all we can to prevent the financial system from so undermining the economy and the wellbeing of the American public.

Though there were many causes of the crisis, the unregulated over-the-counter derivatives marketplace certainly played a central role. Derivatives are contracts used by corporations, municipalities, nonprofit organizations and others to protect themselves from the risk of a future change in markets. Retailers, for example, use derivatives to hedge the risk of currency fluctuations when importing products that consumers will purchase this holiday season. Oil producers use derivatives to lock in the price of oil for future shipments. Local fuel companies use derivatives to lock in the price of winter heating oil for their customers.

The Commodity Futures Trading Commission currently regulates certain derivatives, called futures. Many other derivatives, called over-the-counter derivatives, however, are traded out of sight of federal regulators and out of sight of market participants. These products were at the center of the collapse of Lehman Brothers and the bailout of AIG.

Derivatives play an enormous role in our economy. In America, their total value is based on a dollar amount nearly 20 times the size of our economy. The arithmetic would suggest that, on average, a $50 tank of gas could have as much as $1,000 in derivatives somewhere associated with. The arithmetic also would suggest that, on average, a $200 iPod could have $4,000 in derivatives behind somewhere associated with it.

Most of you have probably heard of a particular type of derivatives called credit default swaps. Those derivatives were at the center of the failure of AIG. There are, however, many other types of derivatives used throughout the economy to hedge or speculate on a wide variety of risks. The largest components of these markets are interest rate and foreign currency derivatives. There are also derivatives on equity securities and on many commodities, including energy, agriculture, the weather and other commodities.

Over-the-counter derivatives are transacted outside of transparent, organized market structures. Rather than being traded on a central exchange or trading venue, over-the-counter derivatives transactions are generally conducted on a bilateral basis with the large financial institutions. This market has become concentrated over time, with five or six big institutions on Wall Street and maybe 15 around the globe, and quite possible will become even more concentrated in the future.

When Wall Street banks enter into derivatives transactions with their customers, they know how much their last customer paid for the same deal, but that information is not made publicly available. They benefit from internalizing this information. For example, when an oil producer wants to hedge the risk that the price of oil will go down and an airline wants to hedge the risk that the price of oil will go up, they both independently transact with the big Wall Street bank. The buyer and seller never meet in a transparent market, and Wall Street profits from wider spreads between the bids and the offers. This is in stark contrast with the regulated futures and securities markets, where the public can see the price of the last transaction traded on a regulated exchange as well as the latest bids and offers.

Can you imagine if other markets operated similarly to the over-the-counter derivatives marketplace, where the dealer is the only one with the information? It would be like buying an apple from the supermarket when the price of the apple is kept private. How would you know if you got a fair price if you didn’t know how much the last person paid for the same apple? Further, it would be like a company issuing bonds but not knowing where they trade. Or like putting 100 shares of a stock into your 401k with no knowledge of where the market prices the stocks. I know that some in this room have expressed concerns about the risk of growing dark pools in the equities markets. In comparison, the over-the-counter derivatives marketplace might be characterized as a dark ocean.

The time has come to bring comprehensive regulation to these markets. We should start by promoting transparency. Economists have for decades recognized that market transparency benefits the public. There are two kinds of transparency: transparency to regulators and transparency to the public. Promoting transparency to regulators is critical to lowering risk and ensuring fair and orderly markets that are free from fraud, manipulation and other abuses.

But, perhaps more important, transparency to the public enables market participants and their consumers to obtain better pricing. This is the transparency that ensures you pay what's fair for an apple or 100 shares of stock. This type of transparency would shift the information advantage from Wall Street to the public, enabling all end-users – from the oil producer to the retail importer – to lower the cost of hedging their risk and thus lower the costs to their customers.

To bring transparency to the public in the over-the-counter derivatives marketplace, the Administration has proposed – and I support – requiring standard products to be transacted on regulated trading venues. Congress has taken historic steps toward bringing transparency to the derivatives marketplace. Some proposals, however, include exemptions for particular transactions from a transparency requirement. While big Wall Street banks would be subject to the requirement when trading with each other, those same Wall Street banks would be exempt when trading with many of their customers. Exempting a large class of transactions, even those with hedgers or other end-users, would reduce the amount of information available to the public and market participants. It is only the Wall Street banks that benefit from such an exemption, not the end-users or the public.

It's only with seeing the price and volume of derivatives contracts in a timely manner that each part of the economy – the retailer, the home heating oil company or the mortgage provider – can get the best pricing, lower their risk and lower the ultimate cost to their consumers. As such, transactions between a Wall Street bank and its customers or end-users should not be exempt from a transparency requirement. Transactions involving financial and corporate end-users are not exempt from trading on existing stock or futures exchanges. We should similarly not exempt standard customer over-the-counter derivative transactions, either with hedgers or a broader group, from a trading requirement.

In addition to bringing transparency to over-the-counter derivatives, we must lower the risk to the American public posed by these markets. Today, large banks enter into over-the-counter derivatives transactions with thousands of counterparties located in every sector of the economy, internalizing their risk. These banks also have other lines of business that can generate financial risks, such as lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Given the interconnectedness of these banks, one bank's failure can have profound effects on every one of its customers or counterparties.

To reduce interconnectedness in the system, standard over-the-counter derivative transactions should be moved into well-regulated clearinghouses. Clearinghouses act as a middleman between two parties in an over-the-counter derivative transaction after the trade is arranged on a transparent trading venue. They require derivatives dealers to post collateral so that if one party fails, its failure does not harm its counterparties and reverberate throughout the financial system. The CFTC and the SEC should have clear authority to determine which contracts are subject to a clearing requirement as well as to use market mechanisms to help make those determinations.

We can best lower risk by bringing all standardized transactions into centralized clearing, including both transactions between Wall Street banks as well as those between a bank and its customers. Some corporations have expressed concerns regarding posting the collateral required to clear a contract. This is a legitimate public policy debate. I believe, however, that the public is best served by lowering risk to the system as a whole, risks that are currently borne by all taxpayers.

To accommodate end-user concerns about posting collateral, corporations and other end-users should be permitted to enter into individualized credit arrangements with the banks that transact on their behalf. Over-the-counter derivatives already carry credit risk. Bringing those transactions into centralized clearinghouses would reduce the risk to both parties to the trade.

I understand that improving transparency and lowering risk would mean big changes for Wall Street. The big banks currently have a significant information advantage over market participants and the public. Those businesses generate tens of billions of dollars in revenue and profits. In maximizing their profits, the banks are simply fulfilling their fiduciary duty to their shareholders. But to best promote market efficiency and economic growth, we must shift the information advantage from Wall Street toward the public.

I speak to you today as someone who spent half my adult life working on Wall Street. I worked with talented individuals from around the world who operated at the highest levels of professionalism. The industry plays a fundamental role in pricing and allocating capital and risk in our economy.

But being talented and working in a critical industry doesn’t mean that individuals can’t make mistakes or that the system is flawless. Last year’s crisis eased only through strenuous effort and some considerable good fortune. Some may accuse us of overreacting and overreaching. But the worst financial crisis in 80 years demands the most comprehensive regulatory reform in generations. We cannot simply repair the cracks in the system, but we must improve the system as a whole.

Thank you for inviting me to speak today. I will now take any questions that you may have. I ask that members of the press save their questions for after today’s event.