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Remarks

Remarks of Chairman Gary Gensler, Over-the-Counter Derivatives Reform, Institute of International Bankers Washington Conference

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Good afternoon. I thank the Institute of International Bankers for inviting me to speak today at your Annual Washington Conference. The 2008 financial crisis was global in nature and requires a comprehensive, international response. That response must include regulatory reform of the over-the-counter derivatives marketplace.

Though there was no single cause of the 2008 financial crisis, it reminded us of the risks that the over-the-counter derivatives marketplace can have on the global economy. Derivatives that are meant to manage and lower risk actually concentrated and heightened risk.

Lowering Risk through Central Clearing

Regulation of the over-the-counter markets must include three critical components of reform. First, we must explicitly regulate derivatives dealers to lower risk. This includes establishing capital and margin requirements, business conduct standards and recordkeeping and reporting requirements. Second, we must bring transparency to the derivatives marketplace by moving standardized derivatives onto regulated exchanges and other trading facilities. This will lower risk to the economy by making it easier to price over-the-counter derivatives. Third, we must reduce interconnectedness in the economy by moving standardized derivatives into central clearinghouses. This afternoon, I will focus my remarks on the benefits that centralized clearing will have for the marketplace, the economy and the American public.

Clearinghouses have effectively reduced risk since they were first developed in the futures markets in the late Nineteenth Century. The Federal Government began regulating clearinghouses after the last great financial crisis in the 1930s – with the CFTC's predecessor regulating clearinghouses for futures and the Securities and Exchange Commission (SEC) regulating clearinghouses for securities and later securities options. Those clearinghouses functioned both in clear skies and during

stormy times – through the Great Depression, numerous bank failures, two world wars and the 2008 financial crisis – to lower risk to the American public.

Over this same time, we have watched repeated cycles in the financial sector where numerous banks and financial institutions have failed, causing great stress to the economy and the public. AIG, for example, did not clear its over-the-counter derivatives transactions through a central counterparty, and its failure left the American public with the burden of paying off its uncleared contracts. In fact, every person in this room has $600 invested in AIG.

Clearinghouses reduce the risk by acting as middlemen between two parties to a transaction and take on the risk that either party might fail to meets its obligations under the contract. 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. Currently, over-the-counter derivatives transactions stay on the books of the dealers that arrange them, often for many years after they are executed. Like AIG, these dealers engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. These dealers often are part of institutions that are both "too big to fail" and "too interconnected to fail." This interconnectedness heightens the risk that a dealer's failure will reverberate throughout the economy as a whole. Uncleared derivatives allow the failure of one institution to potentially cascade, like dominoes, throughout the financial system and ultimately crash down on the public.

Clearinghouse Rules

To ensure fairness and competition in the over-the-counter derivatives marketplace, clearinghouses should have open access, open governance and open membership.

With nondiscriminatory open access, clearinghouses would be required to take on trades from any regulated exchange or swap execution facility. They would not be allowed to discriminate between or amongst the trades coming from one trading venue or another. This would promote competition amongst trading venues as well as allowing the greatest choice among market participants and end-users.

Open governance would ensure that clearinghouses are not governed by parties that might have a conflict of interest or financial stake in particular transactions. Governance should be open to both dealers and non-dealers alike. As clearinghouses have an important say in which contracts are subject to a clearing requirement, it is essential that we remove potential conflicts of interest from that process. Further, the SEC and the CFTC should have clear rule-writing authority to oversee and ensure clearinghouse governance to protect against conflicts of interest, promote open and competitive markets and promote the public interest.

Clearinghouse membership should be open to parties other than derivatives dealers. Assuming a party meets the rigorous risk-management, operational and financial requirements of a clearinghouse, it should be permitted to become a direct member of that clearinghouse. Non-dealer financial institutions or asset managers, for example, may choose in certain circumstances to become a clearinghouse member to reduce

their counterparty risk or to best manage their business. Membership criteria should be transparent, objective and nondiscriminatory.

In addition to rules of openness in clearinghouses, it is important that clearinghouses benefit from open and transparent trading of derivatives on exchanges or other trading venues. This would allow clearinghouses to most effectively price open positions on a daily basis. Trading venues increase transparency and liquidity in the marketplace, making it easier for clearinghouses to manage risk.

Determining What's Clearable

Another critical feature of clearinghouses is determining which contracts or classes of contracts are standard enough to be cleared. Though standardized derivatives should be moved into central clearing, it is important that reform allow for companies, municipalities, nonprofits and other derivatives users to customize or tailor their hedging transactions to meet particular needs. All transactions – both customized and standardized – should have important oversight through the regulation of the dealers. Clearinghouses would further lower risk in the significant portion of the marketplace that is able to be cleared. One Wall Street CEO testified to the Financial Crisis Inquiry Commission in January that he believed that 75-80 percent of transactions are standardized enough to be cleared. I have heard other estimates that two-thirds to three-quarters of the markets are standard. Whatever the proportion of the market, we must bring all standardized products into trading platforms and regulated clearinghouses.

The CFTC and the SEC should have clear authority to determine which contracts are standard enough to be cleared. Clearinghouses and the public have important roles to play in making those determinations as well. The goal is to establish a clearing requirement that covers the greatest possible number of contracts as well as the greatest possible number of transactions in those contracts.

Regulatory Oversight of Derivative Clearinghouses

Derivatives clearinghouses should be robustly regulated to ensure that they do not pose a risk to the economy. Ever since the futures and securities markets came under regulation in the in the early 1930s, the CFTC (and its predecessor) and the SEC have each regulated the clearing functions for the exchanges under their respective jurisdiction. This well-established practice of having the agency that regulates a particular market also regulate the clearinghouses for that market should continue as we extend regulations to cover the over-the-counter derivatives market. Market regulation of clearing, customer protection, segregation rules, trading venues and other components are so closely intertwined that Congress has for decades had them regulated by single regulators – either the CFTC or the SEC. In fact, Congress has stated expressly that the purpose of the Commodity Exchange Act is to ensure the financial integrity of all transactions subject to the CFTC's jurisdiction and the avoidance of systemic risk.

Further, to protect end-users, the CFTC and SEC should have the authority to require derivatives dealers to segregate from their own funds the margin collected from counterparties. Protections should be provided in the bankruptcy code similar to what is

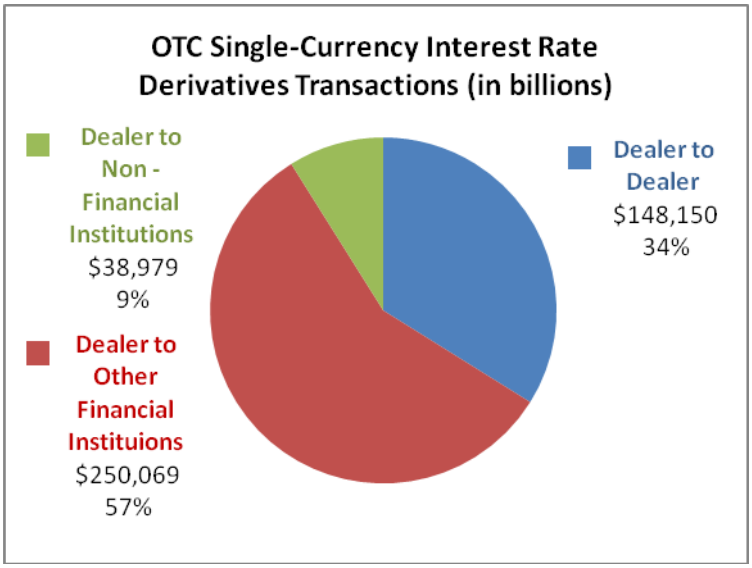
currently available to futures customers. This would help ensure that market participants are protected if either counterparty to over-the-counter transaction experiences financial difficulties.

Exemptions to Clearing Should be Explicit and Narrow

I believe that all standardized over-the-counter derivatives should benefit from central clearing. Some corporations have expressed concerns regarding such a requirement and have called for exemptions from clearing for particular classes of transactions. They are concerned that a clearing requirement may increase their hedging costs or even discourage risk management. It is not clear, however, that posting collateral to clearinghouses would increase costs for end-users because derivatives dealers already charge counterparties for credit extensions when they do not clear their transactions.

I believe that businesses and the public are best served by lowering risk to the system as a whole. If we exempt a large class of transactions from clearing, we will leave significant risk on the books of derivatives dealers. This is the same risk that reverberated throughout the economy during the financial crisis. It is important to note that while no TARP money was used to cover market exposures on cleared transactions, AIG had to be bailed out in part to cover uncollateralized and uncleared derivatives contracts. If certain parties are exempt from clearing their transactions, we should ask ourselves if taxpayers should again be on the hook for that risk.

If Congress ultimately determines that commercial end-users' transactions should be exempt from a clearing requirement, the exemptions should be narrow. Exempting transactions with financial firms exposes the American public to significant risk by leaving the broader financial system exposed and interconnected. Data from the Bank for International Settlements indicates that 57 percent of the over-the-counter interest rate derivatives market is comprised of transactions between dealers and financial end-users. Exempting end-user transactions could leave up to 60 percent of the standardized marketplace out of the clearing requirement.



At a minimum, legislation should mandate that contracts between dealers and other financial firms be cleared on regulated clearinghouses. We do not want transactions

between derivatives dealers and leasing companies, mortgage finance companies, hedge funds or insurance companies exempted from clearing. We will not have protected the public if we leave this interconnectedness in the economy.

Closing

In 2008, we watched the financial system fail. A central lesson from the crisis is that an interconnected financial system facilitates the spread of risk from institution to institution, threatening the entire economy. We must address reduce this risk in the derivatives marketplace to best protect the American public. An effective response requires international coordination. At the conclusion of last year's G-20 summit in Pittsburgh, President Obama, along with other heads of state, made lowering risk and promoting transparency in the over-the-counter derivatives marketplace a key goal. A global crisis demands a global response.

Thank you for inviting me to speak today. I will now take any questions that you may have.