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Remarks

Remarks of Chairman Gary Gensler, OTC Derivatives Regulation, George Washington University Law School Symposium

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Good morning. It is a pleasure to be with you today at one of the defining moments in our nation's financial history. I'd like to thank Professor Mitchell for that kind introduction and George Washington University Law School for inviting me.

One year ago, the financial system failed the American public. The financial regulatory system failed the American public.

Congress responded swiftly to the crisis and committed more than $700 billion of taxpayer money to rescuing the financial industry – without which the financial system never would have stabilized. The crisis was not isolated to Bear Stearns, Lehman Brothers or AIG. It threatened the savings and livelihoods of every American. Let us recall, the financial bailout was only a means of getting a sinking ship back to port. It is now our responsibility to fix the ship before it can set sail again. We must ensure that this type of failure never threatens our nation again.

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 such a critical industry doesn't mean that individuals can't make mistakes or that the system is flawless. The crisis eased only through strenuous effort and some considerable good fortune. Now we must ensure that the risks generated by the financial sector are never allowed to push us so close to the brink again. Some may accuse us of overreacting and overreaching. But the worst financial crisis in 80 years demands the most comprehensive regulatory reform in generations.

Though there are certainly many causes of the crisis, I think most would agree that the unregulated OTC derivatives marketplace played a central role. The time has come for comprehensive regulation.

These markets have a direct effect on everybody in this room. The notional amount of derivatives is between $250 and $300 trillion. That is more than 15 times the size of our economy. If you fill up a tank of gas for $50, that is $750 on average in derivatives that might be behind that tank of gas. Or if you buy an iPod, $3000, on average, in derivatives are somehow related to that.

In just the past two weeks, two important committees in the U.S. House of Representatives – the Financial Services Committee and the Agriculture Committee – both passed historic legislation that, for the first time, introduces comprehensive regulation to the OTC derivatives marketplace.

Both of the committees' bills include three important elements of regulatory reform: First, they require swap dealers and major swap participants to register and come under comprehensive regulation. This includes capital standards, margin requirements, business conduct standards and recordkeeping and reporting requirements. Second, the bills require that dealers and major swap participants bring their clearable swaps into central clearinghouses. Third, they require dealers and major swap participants to use transparent trading venues for their clearable swaps.

Swap dealers are those entities that make markets in derivative instruments. A major swap participant is generally someone other than a dealer who maintains a substantial net position in outstanding swaps other than swaps used for commercial hedging or whose positions create substantial exposure to its counterparties or the system. The proposed legislation requires both swap dealers and major swap participants to register and be subject to comprehensive regulations as these participants are the most relevant to the overall safety of the financial system.

One of the lessons learned from last year's crisis is the financial system can sometimes concentrate and heighten risk. Another lesson is that some institutions had gotten so interconnected that their failure would pose great risk to the economy at large. Today, trades mostly remain on the books of large complex financial institutions, which internalize the volatile risks of their positions. This means that any financial firm is connected with literally thousands of counterparties located in every sector of our economy and in every state in our nation. This left an untenable decision for the government last year. That is why it is so important to move those transactions off the balance sheets and books of those financial institutions.

That's where a clearinghouse comes in. A clearinghouse stands between two counterparties in an over-the-counter derivative transaction to take on the risk of default by one of the counterparties. All OTC transactions, where possible, should be required to be cleared by robustly regulated central counterparties. Many of the institutions that currently keep trades on their books simultaneously engage in many other businesses – lending, underwriting, asset management, securities, proprietary trading and deposit-taking. Clearinghouses, on the other hand, are solely in the business of clearing trades and managing the associated risk. To reduce systemic risk, it is critical that we move all standard swaps off the books of large financial institutions and into well-regulated clearinghouses.

I believe that all clearable transactions should be required to be brought to a clearinghouse, regardless of what type of entity is on either side of the trade. This would remove the greatest amount of interconnectedness from the large financial institutions. While the bills recently passed by the House Financial Services and Agriculture Committees are important steps forward, I believe they can be improved if modified to bring more transactions into central clearing. The bills limit the clearing requirement to transactions between swap dealers or MSPs. Broadening coverage could result in substantial, further reduction in financial system risk. Further improvements could result in the clearing of all clearable transactions where either party is a hedge fund or another financial firm. These entities are responsible for a substantial share of the OTC derivatives market and they are capable of meeting these requirements that have such tremendous promise for the responsible management of financial risk.

Some commercial counterparties have raised concerns about the potential costs of requiring clearing of their transactions. Such concerns could be addressed by permitting end-users to enter into individualized credit arrangements with the clearing members that transact on their behalf, including posting noncash collateral.

If Congress decides, however, to exempt transactions with some end-users from a clearing requirement, that exception should be explicit and narrow. I believe that it is most critical that transactions with financial firms, hedge funds and other investment funds benefit from a clearing requirement. To be clear, these are transactions with entities that are not major swap participants. Let us recall, one of the lessons of last year's crisis was that our government was limited in its options when the big financial firms were in trouble because they were interconnected with thousands of derivatives counterparties. Even though individual transactions with a financial counterparty may seem insignificant, in aggregate, they can affect the health of the entire system. Thus, I look forward to working with Congress to build upon their strong efforts to move more transactions into robustly regulated clearinghouses.

To promote market transparency, all standardized OTC products should be moved onto regulated exchanges or trade execution facilities. This is the best way to reduce information deficits for participants in these markets. Transparency greatly improves the functioning of the existing securities and futures markets. We should shine the same light on the swaps markets. Increasing transparency for standardized derivatives should enable both large and small end-users to obtain better pricing on standard and customized products. A municipality, for example, could better decide whether or not to hedge an interest rate based upon the reported pricing from the broader market. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will benefit all end-users, whether trading with standardized or customized swaps.

I believe that we can separate the debate of a corporate end-user clearing exception from whether there should be an end-user exception from transparency requirements. Transactions between swap dealers and end-users, even if the end-users are exempt from margin requirements, should still be traded on exchanges or swap execution facilities. This will best promote the price discovery function of the markets.

I recognize that the additional transparency afforded through exchange trading would be a significant change for many financial institutions. Transparency benefits the public, shifting some of the information advantage from Wall Street to Main Street. I also understand that lowering risk in the system could affect business on Wall Street. When I worked on Wall Street, I often heard the mantra that “volatility is our friend.” Risk can often mean greater profit margins. But for the American public, volatility was anything but a friend when it resulted in a $700 billion rescue package.

History will judge us based upon how we respond to this call to action. We will be judged on whether we use the lessons of the financial crisis to reform the system or if we allow it to remain unchanged.

Some have articulated a false choice between stronger regulation on the one hand and a free market on the other. Rules improve markets, however, by enhancing efficiency and integrity. Traffic lights require you to stop your car, but they also ensure that traffic is orderly and efficient. They reduce risks for every person on the highway. Similarly, this country’s markets work best with clear rules of the road.

Some have argued that regulatory reform in the United States would send markets overseas. Fortunately, the United States is not alone in its push for comprehensive regulatory reform of the OTC swaps markets. On Tuesday, the European Commission announced a broad agenda to reform derivatives regulation. The European Commission’s plan includes a central clearing requirement, requires higher capital for customized swaps and mandates exchange-trading of all standardized products. It is encouraging that Europe and the United States are moving in the same direction regarding regulatory reform. Through a cooperative effort, we can best protect the global financial system.

I do believe that much needs to change to protect the American public – both in the markets that are currently regulated and in the over-the-counter markets. We must ensure that last year’s crisis was the last.

Thank you for inviting me to speak today. I will now take any questions that faculty, staff, students or members of the public may have. I kindly ask that the press save their questions for after the Q and A.