



## **Commodity Futures Trading Commission**

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# **Remarks**

## **Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Atlantic Council**

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Good evening. I thank the Atlantic Council for inviting me to speak today. The topic of this speaker series, "Mapping the Economic and Financial Future," is of utmost importance. We suffered through the worst crisis in 80 years – a crisis where both the financial system and the financial regulatory system failed the American public.

A healthy financial future requires that we bring comprehensive reform to the over-the-counter derivatives markets. It is critically important that we bring transparency to this market and address the significant information advantage enjoyed by Wall Street. This will improve pricing and lower costs for businesses and their consumers.

Economists and policymakers have for decades recognized that market transparency benefits the public. In the aftermath of the last great financial crisis, President Franklin Roosevelt worked with Congress in the 1930s to bring regulation to the futures and securities markets. Futures and securities were not only regulated against fraud and manipulation, but also were regulated to ensure transparency and competition in the marketplace. Companies that need to raise capital or borrow capital, for example, can see and rely upon where other companies have priced their securities. Hedgers and speculators can see where futures trade in a marketplace to get the best pricing. All market participants and the public benefited from the great reforms of the 1930s that regulated securities and futures.

Today, we are faced with a similar set of choices. An opaque market, concentrated with a small number of financial institutions, contributed to a financial system brought to the brink of collapse. Roosevelt and his administration recognized that transparency, a key to market-based reform, was critical to ensuring that a market functions well. We now must bring a similar level of transparency – and benefit to the public – to the derivatives markets. The more transparent a marketplace is, the more liquid it is for standardized instruments. The more transparent a marketplace is, the more competitive it is. And the more transparent a marketplace is, the lower the costs for hedgers, borrowers and, ultimately, their customers. The best way to bring transparency is through regulated

trading facilities and exchanges. Such centralized trading venues not only bring greater transparency, but increase competition in the markets by encouraging market-making and the provision of liquidity by a greater number of participants. A greater number of market makers brings better pricing and lowers risk to the system.

The over-the-counter derivatives markets began in 1981 and remain to this day largely unregulated. Derivatives are contracts used to hedge against the risk of a future change in markets, such as changes in the price of a particular commodity or changes in a currency or interest rate. The early stage of this new market was highly tailored to meet hedgers' specific needs. Contracts were negotiated between a dealer and a corporation seeking to hedge a risk. The contracts were bilateral with banks taking these contracts onto their balance sheets, assuming the risk as well as the potential profit.

In the last three decades, the over-the-counter derivatives marketplace has evolved significantly, ballooning to approximately \$300 trillion in notional value in the United States – that's nearly 20 times the size of the American economy. The contracts have become much more standardized, and rapid advances in technology – particularly in the last ten years – facilitate more efficient trading.

While this marketplace has changed so significantly, the constant is that it remains dealer-dominated. Wall Street retains the information advantage. When a Wall Street bank enters into a bilateral derivative transaction with a customer, the bank knows how much its last customer paid for similar transactions, but that information is not generally made available to other customers or the public. The bank benefits 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 or jet fuel will go up, they both independently transact with a big Wall Street bank. The buyer and seller do not meet in a transparent market. In the opaque over-the-counter market that exists today, Wall Street profits from the spreads between the bids and offers that are wider than they would be in a transparent market. 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.

We would not tolerate it if other markets operated similarly to over-the-counter derivatives, where dealers are the only ones with much of the relevant 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? If you are running low on gas and need to find a local gas station to fill up, the pricing is listed in plain sight of every driver on the road. If you pass two competing gas stations on the highway, you can tell which station sells less expensive gas and choose to fill up at that one. Imagine buying 100 shares of a stock for your 401(K) with no knowledge of where the market prices the stock. Imagine a corporate treasurer seeking to raise capital or repurchase company shares without benefiting from a transparent and competitive market, with no knowledge of the pricing of their stock and bond transactions. Likewise, the benefits of a transparent, centralized marketplace should be made available to all users of standard over-the-counter derivatives.

Some have said that we can address transparency through recordkeeping and reporting of derivatives transactions to the regulators. Though promoting disclosure to regulators is critical to lowering risk and ensuring that markets are free from fraud, manipulation and other abuses, it does not address the need for public market transparency. This public transparency would enable all market participants – from the oil producer to the retailer importing products – to lower the cost of hedging their risk. This would lower costs to their customers and lower risk to their enterprises. To bring this much-needed public market transparency, all transactions in standard contracts should be required to be conducted on regulated trading facilities or exchanges.

Some opponents of reform argue that the lack of transparency was not at the center of the crisis. The lack of transparency, though, was at the core of the crisis. The inability to price many complex mortgage securities created a new word in the public lexicon: “toxic assets.” “Toxic assets” are loans and securities held by banks that were too difficult to price because there was no transparent pricing for them or their component parts. The ability to price derivatives via a centralized marketplace would provide much-needed reference to price over-the-counter derivatives as well as the “toxic assets” that were often based upon similar underlying risks.

Some opponents of reform have welcomed bringing transparency to the over-the-counter derivatives markets, but only if it comes with significant exemptions for many of the transactions. While big Wall Street banks might be subject to the requirement when trading with other banks, they call for exemptions when trading with many of their customers. This has been called the “end-user exemption,” as transactions with certain end-users, such as businesses, municipalities and nonprofit organizations, would not be subject to a transparency requirement.

Exempting an entire class of transactions would reduce the amount of information that would otherwise be available to the public and market participants. Data collected by the Bank for International Settlements indicates that though approximately 40 percent of over-the-counter derivatives are transacted between two reporting derivatives dealers, the remaining are between those dealers and their financial and corporate customers. Depending on how an end-user exemption is crafted, a significant portion of the other 60 percent of standardized over-the-counter derivatives volume could be left in the opaque, bilateral over-the-counter markets.

Through seeing the price and volume of derivatives contracts in a timely manner, each actor in 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. Corporate treasurers across America would find that access to trading screens greatly enhances their ability to determine the best price to hedge their risks. As a driver can best decide which gas to buy based on public prices posted at each gas station, corporations could better decide how to manage the risks associated with their business if they knew how much others were paying to manage similar risks. As such, it is the Wall Street banks that benefit from the so-called “end-user exemption” from transparency, not the businesses that use derivatives.

We also must lower risks to the system created by over-the-counter derivatives transactions. Derivatives are intended to help transfer and lower risk in the economy, but the financial crisis demonstrated that they also can concentrate risk among a few

big banks. To reduce interconnectedness and lower risk 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. 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.

Some have said that they like the idea of bringing transparency to the over-the-counter markets, but they do not support posting collateral to clearinghouses. They ask if transparency necessitates central clearing. My answer is no. Though I see the public policy benefit of clearing all standardized transactions, reform can nevertheless separate the two, requiring that all standardized derivatives are traded without requiring that those derivatives be cleared. In fact, one trading platform provides such a service today. On that platform, the end-users can decide if they want to clear their transactions through a central clearinghouse or settle them on a bilateral basis with counterparties with whom they have established a credit arrangement. The technology exists today to separate a transparency requirement from clearing.

I understand that improving transparency and lowering risk would mean significant changes for Wall Street. I worked on Wall Street for 18 years with talented individuals from around the world who operated at the highest levels of professionalism. Wall Street's interests are not always the same as the general public's interests. In maximizing their revenues, the banks are pursuing their fiduciary duty to their shareholders and, as ever so evident by this year's bonus season, to further employee compensation as well. They do not owe a similar duty to the taxpayers. In fact, they have made their case against many important aspects of reform on Capitol Hill. But in 2008, we watched the financial system fail. It is time to change the way the over-the-counter derivatives markets function and move from a dealer-dominated market to a transparent central marketplace that benefits the public and protects the American taxpayers.

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