Commodity Futures Trading Commission
Office of Public Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
202.418.5080

Remarks

Remarks of Chairman Gary Gensler, Over-The-Counter Derivatives Reform

Women in Housing and Finance

March 2, 2010

Good afternoon. Thank you for inviting me to be with you. I am honored to be back with the Women in Housing and Finance again. I look forward to a vibrant discussion about some of the most important elements of financial regulatory reform. The 2008 financial crisis left us with many lessons and many challenges to tackle. Though there were certainly many causes of the crisis, I will focus my remarks today on the need to regulate over-the-counter derivatives.

CFTC Regulatory Regime

I recognize that many of you have familiarity with the CFTC, but for those who don't, I will take a moment to discuss the CFTC's current oversight of the futures markets. Futures have traded since the Civil War, when grain merchants came together to hedge the risk of changes in the price corn, wheat and other grains on a central exchange. It took nearly 60 years until Congress first brought Federal regulation to the futures markets, and it wasn't until the 1930s that the Commodity Exchange Act, which created the CFTC's predecessor, became law.

The CFTC ensures that futures and commodity options exchanges protect market participants and promote fair and orderly trading, free from fraud, manipulation and other abuses. Exchanges are where buyers and sellers meet and enter into transactions. The CFTC also oversees clearinghouses, which enter the picture only after two counterparties complete a transaction. Clearinghouses act as middlemen between and guarantee the obligations of the two parties to the trade and take on the risk that one party may fail to meet its obligations for the duration of the contract.

The CFTC has wide-ranging transparency efforts designed to provide the public much information about commodity futures markets and trading and has broad surveillance and enforcement powers to police the markets. We also oversee those entities that hold themselves out to advise the public on the futures markets.

Over-the-Counter Derivatives Regulation

Nearly 60 years after the futures markets were regulated, the first over-the-counter derivative transaction took place in 1981. During its early years, the over-the-counter marketplace was highly tailored to meet specific risk management needs. Contracts were negotiated between dealers and their corporate customers seeking to hedge specific financial risks. In contrast to the regulated futures markets, over-the-counter derivatives were not traded on exchanges. Dealers kept transactions on their books, leaving the financial institutions more interconnected with all of their customers and limiting the amount of relevant pricing information available to the public.

In the last three decades, the over-the-counter derivatives marketplace has grown up, but it remains largely unregulated. Since the 1980s, the notional value of the market has ballooned from less than $1 trillion to approximately $300 trillion in the United States – that's $20 in derivatives for every dollar of goods and services produced in the American economy. The contracts have become much more standardized, and rapid advances in technology now facilitate transparent trading on electronic platforms. While so much of this marketplace has changed, it remains largely unregulated and dealer-dominated.

It is now time to bring comprehensive regulation to this marketplace. In well functioning markets, derivatives are meant to mitigate and help manage risk in the economy. The financial crisis dramatically revealed how unregulated over-the-counter derivatives markets actually can heighten and concentrate risk to the detriment of the American public.

Effective reform requires three essential components: First, we must establish an explicit regulatory framework for derivatives dealers. Second, we must increase transparency by requiring that standardized derivatives be traded on regulated trading platforms, such as exchanges. Third, we must lower the risk to the American public of financial institutions that have become both "too big to fail" and "too interconnected to fail" by requiring that their standardized derivatives be brought to central clearinghouses.

Regulating the Dealers

There is now broad consensus that dealers should be regulated for all of their derivatives business, both customized transactions and standardized ones. Dealers should maintain sufficient capital and meet margin requirements to lower risk to the American public. They should be required to meet business conduct standards to promote market integrity by protecting against fraud, manipulation and other abuses and to lower risk through uniform back office standards for netting, processing and documentation. Dealers also should meet recordkeeping and reporting requirements promoting transparency to the regulators.

Transparent Trading Requirement

It is not enough, though, simply to promote transparency to the regulators. Financial reform will be incomplete if we do not make the over-the-counter derivatives marketplace transparent to the public. An opaque derivatives market, concentrated

amongst a small number of financial institutions, contributed to bringing our financial system to the brink of collapse. Public market transparency greatly improves the functioning of existing securities and futures markets. We should shine the same light on the over-the-counter derivatives markets.

The more transparent a marketplace, the more liquid it is, the more competitive it is and the lower the costs for corporations that use derivatives to hedge their risks. The best way to bring transparency is through regulated trading facilities and exchanges. Such centralized trading venues also 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.

Further, clearinghouses would be far more able to assess and mange the risk of over-the-counter derivatives with the benefit of transparent trading markets. A critical element of managing clearinghouse risk is marking all cleared positions to a reliable and transparent market price. Absent the transparency provided by trading venues, clearinghouses have less reliable prices when marking to market the derivatives they clear and, thus, are less able to manage their risk and protect the public.

Some on Wall Street have said that they see no need for a transparency requirement. But make no mistake: transparency is an absolutely essential component of reform. Congress should require that all standardized over-the-counter derivative transactions be moved onto regulated transparent exchanges or trade execution facilities.

Mandating Clearing of Standardized Derivatives

Currently, over-the-counter derivatives transactions stay on the books of the dealers often for many years after they are arranged. These dealers engage in many other businesses, such as lending, underwriting, asset management, securities trading and deposit-taking. When there is a better alternative through central clearing, why leave these derivatives transactions on the books of the derivatives dealers when these institutions are possibly "too big to fail?" Bilateral derivatives also leave a financial institution possibly "too interconnected to fail." Leaving these transactions on the books of the banks further aggravates the government's dilemma when faced with a failing institution.

Therefore, Congress should require derivatives dealers to bring their completed standardized derivatives transactions to regulated clearinghouses. By some estimates, more than three quarters of the over-the-counter market could be cleared by a clearinghouse. Contracts that are so tailored that they cannot be cleared by a clearinghouse should be allowed to be transacted bilaterally, with the dealers subject to comprehensive regulation for these transactions. Central clearing would greatly reduce both the size of dealers as well as the interconnectedness between Wall Street banks, their customers and the economy.

Some corporations have expressed concerns regarding posting the collateral required to clear a contract. While this is a legitimate public policy debate, I believe that the public is best served by lowering risk to the system as a whole. An exemption from clearing for this large class of transactions would allow dealers to keep significant risk on their books – risk that could reverberate throughout the entire financial system if a

bank fails. Further, it is not clear that posting collateral increases costs to end-users, since dealers charge corporations for credit extensions when the corporations do not post margin.

If Congress ultimately determines that commercial end-users' transactions should be exempt from a clearing requirement, the exemptions should be narrow. Exempting transactions with non-dealer financial firms exposes the American public to great risk by leaving the broader financial system significantly interconnected. At a minimum, legislation should mandate that trades between dealers and other financial firms be cleared on regulated clearinghouses. Hedge funds, for example, should not be exempt from a clearing requirement.

Further, any commercial end-user exception from clearing should not bring along an exemption from a transparency requirement. Even if they are exempt from posting collateral to a clearinghouse, commercial end-users would benefit from greater transparency than Wall Street currently provides.

AIG and Greece

Before I close, I would like to address how these reforms might have affected the cases of AIG and Greece's apparent use of a derivative to obscure its level of debt.

While we can neither replay history nor have any certainty of how things would have been different, I am confident that derivatives reform would have added significant protections for the public. AIG's derivatives affiliate, which was based in London and also traded out of Connecticut, would have been explicitly regulated. AIG would have been required to have capital to act as cushion in the event that the company failed. Further, 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. With the reforms I've discussed today, AIG would have been required to post margin to a clearinghouse for its standardized contracts, and regulators would have authority to require capital and margin on the customized contracts as well. When AIG's credit rating was downgraded in the fall of 2008, the company was unable to fund the approximately $30 billion in margin calls. Reform also would have lessened the interconnectedness of AIG. Of the $180 billion made available to AIG, we later learned that tens of billions of dollars flowed through AIG to other financial institutions in the United States and Europe to cover uncollateralized exposures. Transparency in the derivatives markets also would have given regulators a clearer picture of AIG's derivatives exposures.

The recent chill winds affecting the Euro have revealed how derivatives can be used by a sovereign country, such as Greece, to borrow money from a financial institution while obscuring the embedded loan. Of course, there are many things unrelated to derivatives that are affecting the Euro and Greece's debt. Still, derivatives reform would have made it more difficult for Greece to hide their embedded loan. I understand from press reports that Greece's derivatives transaction was an off market transaction. When the contract was written, Greece apparently had net exposure of $1 billion. If this transaction was centrally cleared, it would have required Greece to post $1 billion in collateral on the day of the transaction, thus cancelling out the embedded loan and discouraging the country from entering into such a transaction in the first place. Even if

it were deemed to be a customized transaction and outside of central clearing, reform would have allowed regulators to set capital, margin and business conduct standards for such off market transactions. Derivatives reform also would have promoted transparency to regulators and the public.

Closing

In 2008, we watched the financial system fail. The crisis reminded us of the great challenges facing our economy. It is essential that we bring regulatory reform to the derivatives markets to best protect the American public.

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