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# Remarks

## Remarks of Chairman Gary Gensler, "OTC Derivatives Reform", Council on Foreign Relations

### January 6, 2010

Good morning. I thank Professor Merit Janow for that kind introduction and the Council on Foreign Relations for inviting me to speak. I also want to wish you a happy new year. I hope that the new year will bring all that you wish it to bring. For me, that is financial regulatory reform. And of course that my daughter get into the college of her choice.

The 2008 financial crisis left us with many lessons and many challenges to tackle. From addressing institutions that are too big to fail to reforming mortgage underwriting and sales practices, it is essential that the Federal Government take significant steps to prevent the next crisis. This morning, I will focus on the need for comprehensive reform of over-the-counter (OTC) derivative markets.

In the year since the crisis, some have asked: why is it important to bring greater regulation to derivatives now?

The financial crisis certainly highlighted the need for regulatory reform of the derivatives marketplace. Had the crisis not occurred, however, the evolution of these markets would still warrant broad reform.

Derivatives are contracts used by corporations, municipalities, nonprofit organizations and others to protect themselves from the risk of a future change in markets. Every consumer is touched by corporations that use derivatives. Some of these corporations hedge interest rate risks; some purchase products from a supplier who hedged a currency rate. If you flew to visit your family over the holidays, the airline most likely hedged its risk that the price of jet fuel would increase. Local fuel companies use derivatives to lock in the price of winter heating oil for their customers.

Many derivatives, called futures, are currently regulated by the Commodity Futures Trading Commission. Futures are standardized, liquid derivative contracts that have traded on exchanges since the 1860s. They are used to hedge many different types of risks. Initially futures products covered agricultural commodities, such as corn and

wheat. They allowed farmers to both hedge a future price risk and get the benefit of the price established through a national market rather than just with a local dealer. After much debate, these markets were regulated in the 1920s – more than sixty years after the first contracts were traded. Over the next sixty years, though futures trading expanded to cover energy products and financial products, Congress responded to ensure that all of these products were traded on central markets and covered by regulation.

Things started to change in 1981 with the first over-the-counter derivative transaction. 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 grown up. It is certainly no longer in its embryonic stage, but it remains unregulated. From total notional amounts of less than $1 trillion in the 1980s, the notional value of this market has ballooned to more than $300 trillion in the United States – that's more than 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 so much of this marketplace has changed significantly, the constant has been that it is still dealer-dominated.

When a corporation or another end-user wants to hedge a risk, they go to their bank and get a price quote. When they enter into transactions, those transactions largely stay on the books with their banks. The price is not discovered on transparent trading venues, such as exchanges, and the risk is not transferred from the dealer's books to a central clearinghouse. This leaves significant risk in the system, risk that a year ago was borne by the taxpayers in the form of the largest financial bailout in history.

Much like the debate after the last great crisis in the 1930s about potential regulation for both the futures and the securities markets, we are now debating whether the over-the-counter derivatives market should be regulated. While the recent crisis seems to have eased and many banks are repaying TARP money, I believe that we still must enact regulatory reform to promote transparency and reduce risk in the evolving over-the-counter derivatives markets.

Financial intermediation – that is, the pricing and allocation of capital and risk – is critical to every part of our economy. This intermediation can either be done through financial institutions – typically banks – or through the benefit of a centralized marketplace. The more standard the products are, the more able they are to trade in a marketplace. For example, investors buy and sell stocks in a marketplace.

Over-the-counter derivative contracts have become much more standardized. In fact, by some estimates, between two thirds and three quarters of interest rate derivatives and credit default swaps could be standardized. In energy and other commodity markets, some estimates are that approximately half could be standardized. With the standardization and computerization of derivative transactions, the time has come to bring the benefits of a central marketplace that lowers risk and allows market participants to see how contracts are priced.

Some opponents of reform argue that derivatives were not at the center of the crisis and should thus not be regulated. I believe, however, that over-the-counter derivatives were at the heart of the crisis. We have all witnessed firsthand the effects that unregulated derivatives 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.

But the lessons from the crisis go far beyond AIG. While derivatives are intended to help transfer and lower risk in the economy, the financial crisis demonstrated that they also can concentrate risk among a few big banks. All of the major derivatives dealers – all recipients of taxpayer TARP money – internalize their derivatives trading, retaining significant risk. Those banks have become increasingly interconnected with other institutions. The market also has become highly concentrated, with five or six big institutions on Wall Street and maybe 15 around the globe dealing in derivative products. Risk becomes like a spider's web that spreads throughout the economy. Data collected by the Bank of 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. When the financial system failed, those risks were externalized to the public in the form of a taxpayer-funded bailout.

I believe comprehensive reform must include three key components. First, we must explicitly regulate the derivative dealers. Leading up to the financial crisis, it was assumed that the banks that deal in derivatives were already regulated, and thus did not need to be explicitly regulated for their derivative transactions. The financial crisis demonstrated that this was a flawed assumption. While banks and securities firms were regulated by their prudential regulators, their affiliates that traded derivatives were often left ineffectively regulated – that was the case for Lehman Brothers and AIG. Even though derivatives were traded inside a regulated bank, the banks were not regulated explicitly for their derivatives trading.

Second, regulatory reform must bring sunshine to the opaque over-the-counter derivatives markets. Over-the-counter derivatives are traded out of sight of federal regulators and out of sight of market participants. This was at the core of the financial crisis. We all recall in the midst of the crisis the inability to price particular mortgage derivatives. The public learned a new term – "toxic assets" – assets held by banks that were too difficult to price. Bringing transparency to the over-the-counter derivatives markets shifts the information advantage from a small group of derivative dealers on Wall Street to the broader market. This not only benefits end-users, but increases competition in the markets by lowering the barriers to entry for additional market makers and liquidity providers. A greater number of market makers also lowers risk to the system and provides greater liquidity.

We would not tolerate if other markets operated similarly to over-the-counter derivatives, 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 putting 100 shares of a stock into your 401k with no knowledge of where the market prices the stocks. It is essential that we

bring the benefits of a transparent marketplace to the opaque over-the-counter derivatives markets.

Third, to reduce interconnectedness in the system, standard over-the-counter derivative transactions should be moved into well-regulated clearinghouses. In the over-the-counter derivatives markets, trades are left on the books of the dealers after they are transacted. An interest rate derivative, for example, could stay on a dealer's books for many years. As markets move, the value of those transactions change, but interconnectedness remains. The crisis showed how this interconnectedness concentrates and heightens risk to the American public.

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. It is essential that we reduce this risk in the system. Otherwise, we could see a repeat of the financial crisis as the risk is externalized and the taxpayers are left on the hook.

I understand that improving transparency and lowering risk would mean big changes for Wall Street. We would move standardized over-the-counter derivatives out of a dealer-dominated market and into a centralized marketplace. 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 American public's interests. In maximizing their profits, the banks are fulfilling their fiduciary duty to their shareholders, but they do not owe a similar duty to the taxpayers. We watched in 2008 when the financial system failed. It is time to change the way these markets function and the way they are regulated to benefit the public and to protect the American taxpayers.

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 hold their questions until a press availability after this morning's event.