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

Speech

Speech of Chairman Gary Gensler, Commodity Futures Trading Commission, OTC Derivatives Regulation, European Commission

September 25, 2009

Good morning. It is a pleasure to be in Brussels with you today. Thank you to the European Commission for hosting this important conference. Thank you Commissioner Charlie McCreevy and David Wright for inviting me to speak today.

One year ago, the financial system failed. The financial regulatory system failed. We must now do all we can to ensure that it does not happen again. While a year has passed and the system appears to have stabilized, we cannot relent in our mission to vigorously address weaknesses and gaps in the global financial regulatory system. As a critical component of reform, I believe that we must bring comprehensive regulation to the OTC derivatives markets. We must lower risk, promote greater market integrity and improve market transparency.

We have all felt the effects of the failures of our regulatory system. Every U.S. taxpayer, for example, put money into a company that most Americans had never even heard of. $180 billion of those tax dollars went into AIG to keep its collapse from further harming the broader global economy. AIG, though a U.S.-based company, highlights how interconnected the global financial system has become. As the world came to discover, AIG had a large book of business – approximately $450 billion net notional value – of credit default swaps. About two thirds of that business was written to support regulatory capital of major banks, primarily right here in Europe. The other third of the business was written largely on mortgage securitization products. When the U.S. government first put money into AIG last year, about two thirds of the first approximately $90 billion flowed through AIG to its counterparties outside of the United States. AIG demonstrates the interconnectivity of the global financial markets and the need for all financial regulators to work together on a global solution.

AIG is only a single company. The buildup of highly leveraged risk extends far beyond a single company's trading. The largest banks in Europe and the United States have significant OTC trades totaling trillions of dollars in notional value and hundreds of billions of dollars in exposure. AIG shows that sometimes institutions are not only too big to fail, but too interconnected to fail. No nation can afford more multi-billion-dollar bailouts.

The need for reform of our financial system parallels what the United States as a nation faced in the 1930s. The Great Depression made clear that the United States needed comprehensive reform to protect the public from future failures of the financial system. Our nation then responded by establishing two market regulators – the CFTC to regulate the markets for risk management contracts, called derivatives contracts, and the Securities and Exchange Commission (SEC) to oversee the securities markets. Now, as the global financial system continues to recover from last year's crisis, we must work together across borders to ensure that we do not again face a similar crisis. This requires applying comprehensive regulation to OTC derivatives.

Regulation of OTC derivatives will require two complementary regimes – one for regulation of the derivatives dealers, or the actors, and one for regulation of the derivatives markets, or the stages.

The banks that deal in derivatives should be required to meet capital standards and margin requirements to help lower risk. These dealers also should have to comply with business conduct standards to promote market integrity by preventing fraud, manipulation and other abuses. To promote transparency, a comprehensive reporting and recordkeeping regime should be established for swaps, including swap repositories.

The markets where derivatives trade also should be comprehensively regulated. We should mandate that all standardized derivative products be cleared by a central clearinghouse to lower risk. We should improve market transparency and efficiency by moving standardized OTC derivatives onto regulated exchanges or regulated trade execution facilities.

Effective, comprehensive regulation of the OTC derivatives markets will require a great deal of international cooperation and a consistent regulatory framework. In that vein, I will use my remaining time to address five important issues to consider as the United States and our European partners work to regulate the OTC markets.

First, we should not limit regulatory reform to only those products or entities that received the most attention during the financial crisis. A comprehensive regulatory framework must cover all of the different products. This includes interest rate swaps, currency swaps, commodity swaps, equity swaps and credit default swaps, as well as all of the derivatives products that may be developed in the future. To limit reform to one financial product would leave other products to be traded in inefficient and opaque markets. Credit default swaps may have been a leading culprit of this crisis, but the markets for interest rate swaps, currency swaps and commodity swaps are just as opaque. We should shine the same light and lower risk on all OTC derivatives.

Second, we must implement complementary regulatory regimes that cover both the markets and the dealers. Only by comprehensively regulating the institutions that deal in derivatives can we oversee and regulate the entire derivatives market. Through regulating the dealers, we can ensure that regulations apply to both standardized and customized products. This would ensure that corporations and other hedgers could still tailor their risk management needs and the public would still be protected through regulation of these customized products. By giving regulators a clear authority to set business conduct standards, we can mandate the dealers to have consistent processing and legal terms for derivatives. Regulating the dealers is also the only way that we can ensure against having ineffectively regulated institutions, such as AIG, in the future.

Third, to further promote market transparency and efficiency, the standardized part of the OTC markets should be required to move onto regulated exchanges or regulated trade execution facilities. Exchanges greatly improve the functioning of the existing securities and futures markets. This is through the transparency provided both prior to the trade and post the trade. We should bring the same transparency and efficiency to the OTC swaps markets. Increasing transparency – including a consolidated reporting tape – for standardized derivatives would give both large and small end-users better pricing on standard and customized products.

Whether an oil producer or a company hedging a financial risk, that entity could better decide whether or not to hedge based upon the reported pricing from the exchanges. As customized products often are priced in relation to standard products, I believe that mandated exchange trading will enhance the ability of all end-users to effectively manage their risk, whether hedging or trading with standardized or customized swaps.

One of the key lessons of last year's crisis is that there was a lack of pricing information on so many complex financial assets. Transparent pricing in the risk management markets of OTC derivatives would allow for less uncertainty in pricing even on non-derivative assets.

Fourth, regulators must have access to information on all OTC trades to properly asses risk and police these markets. Under the U.S. proposal this would be accomplished by requiring all trades to be reported to a transparent trade repository or a clearinghouse. I understand that Europe is moving in a similar direction on this issue. As we move forward to establish such trade repositories in both the U.S. and in Europe, we should create a common reporting framework so that appropriate information can be shared among the regulators.

Fifth, central clearing should be required for all standardized OTC derivatives. I believe that incentives alone will not work. Centralized clearing should be mandated for all standardized OTC derivatives. All derivatives that are accepted by central counterparty clearing should be considered "standardized" and thus required to be cleared. Moving bilateral trades into regulated clearinghouses will reduce the risk that a failure of one firm will cause other firms to fail.

Clearinghouses should be required to establish and maintain robust margin standards and other necessary risk controls and measures. It is important that we incorporate the lessons from the current crisis as well as the best practices reflected in international standards.

To promote transparency and competition, central counterparties should be required to have fair and open access criteria. First, to promote competition among exchanges and trading platforms, clearinghouses should be required to take on OTC derivatives trades from any regulated exchange or trading platform on a nondiscriminatory basis. Second, clearinghouses should accept as clearing members any firm that meets objective, prudent standards to participate, regardless of whether it is a dealer or another type of trading entity. Clearinghouses also should have open governance that incorporates a broad range of viewpoints from members and other market participants.

I think that we should avoid mandating specific geographic locations for clearinghouses. Mandating a location for clearing may decrease efficiency – such as in capital allocation – and may increase risk. Allowing market participants to choose between robustly supervised clearinghouses allows participants to most efficiently participate in central clearing. To address legitimate supervisory interests, we can develop an appropriate and cooperative supervisory process for central counterparties. As part of this, we are committed to sharing appropriate information with foreign regulators, regardless of the location of the central counterparty, to best reduce risk.

International coordination is essential to ensure comprehensive regulation of the OTC derivatives markets. We must not leave gaps in our regulatory structure that allow traders to evade one country's regulations by taking their business elsewhere.

I look forward to continuing to work with the European Commission. It is in this vein that I am here today. We have a tough job ahead of us, but it is essential that we get it done to protect the financial markets, the broader economy and the public.

Thank you for inviting me to speak today.