**MEMORANDUM FOR THE RECORD**

Event: Gary Gensler, CFTC Chairman

Type of Event: Group interview

Date of Event: May 27, 2010, 10:00 am

Team Leader: Chris Seefer

Location: 1155 21st Street, NW, Washington, DC 20581

Participants - Non-Commission:

* Gary Gensler, Chairman
* Dan Berkovitz, General Counsel
* Cyrus Amir Mokri, Senior Counsel to the Chairman

Participants - Commission:

* Chris Seefer
* Randall Dodd
* Greg Feldberg
* Donna Norman

MFR Prepared by: Greg Feldberg

Date of MFR: May 28, 2010

Summary of the Interview or Submission:

* Derivatives transfer risk and sometimes concentrate it; they don’t lower it. Prior to the crisis, we regulated the insurance companies that would hold the risk.
* But AIG didn’t have the typical *risk mitigants*, in particular it wasn’t required to post collateral or hold sufficient capital against its credit derivative positions.
  + OTS is partly to blame because it was paying attention to AIG FP.
  + The rating agencies are partly to blame because AIG’s CDS business was built around *renting of credit ratings.* [Is renting of credit ratings simply a bad thing or was it just poorly managed?] A little of both.
  + Two-thirds of AIG’s CDS business was for European banks seeking to lower their capital charge under Basel II. Basel III [the changes proposed in July and December 2009] should have some restrictions on that. It was so concentrated. One-third was CDOs. [At its maximum, AIG’s CDS on CDOs was about $80 billion].
* Another way to look at this is *renting credit judgment.* This made sense for the monolines, for MBIA, Ambac, etc. Credit default swaps looked a lot like monoline insurance.
  + This was called bond wraps.
  + The investor took comfort in the AAA rating. They only had to do due diligence on MBIA. They could do zero review on the assets themselves.
  + [Role of monolines?] “That’s central to this crisis.”
* This crisis was worse than the stock market crash in 2000-2001, which hurt a lot of investors. This time it was different because it was a levered asset class. If prices drop 10% you’re easily underwater.
* [Role of derivatives in the crisis?] “Credit default swaps made this much worse because it helped fuel the asset price bubble.”
  + “Beyond the CDS story, derivatives generally allow for greater leverage.” Other than credit derivatives have not shown to be central to commercial banks’ leverage story. They are a way to take on risk with very little capital.
* [Role of capital charges?] The capital charge won’t reflect what I’ve bought. It’s much lower than if the bank held the actual asset. They are a very important hedging tool. There’s a strong case that capital should be consistent wherever you hold the risk. But there are some differences between holding a loan and a CDS.
* [What to do about CDS?] The administration has said, first get them on a clearinghouse, second, ever if they are customized and can’t trade on the clearinghouse, the dealer should be required to post and receive margin.
  + [Is the ISDA Master Agreement sufficient?] Some don’t have collateral requirements under the Credit Support Annex.
* [What authority did bank regulators have to address these issues prior to the crisis?] Bank regulators have had authority for decades to say to banks how to manage their risks, if it was inside the banks, and this activity usually was. It was different at investment banks, they put them outside the broker-dealer. Starting in 1997 these units were subject to “broker-dealer lite.”
* The New York Fed has done a good job of using the New York Fed (moral authority) to get consensus on back office issues. Theo Lubke should be complimented.
* Derivatives make the system more interconnected. It’s hard for a single firm to fail.
* [Clearinghouses?] LCH Swap Clear started around 2000. It now clears $215 trillion in interest rate swaps. That does include double counting so the number is about $107 trillion.
  + LCH was able to help after Lehman. “That is a risk reducer. It’s critical that we expand that.”
* Right now, the largest financial institutions are central counterparties for their whole book. There’s about five in the US and another four or five in the UK and Europe. However, there’s a difference. They aren’t managed as clearinghouses, and they’re in other businesses. Imagine DTCC saying we want to be a securities underwriter. It wouldn’t take long for the regulators to say no to that one.
  + [Why are they not managed as clearinghouses?] Clearinghouses ask for margin to prepare for a counterparty failure. Clearinghouses have capital dedicated to handling failures. Clearinghouses have a mutual risk pool which all members contribute to. Clearinghouses aren’t in other businesses.
  + Clearinghouses work really well. Few have ever failed anywhere.
  + [Why are these institutions like central counterparties?] All of these companies – JPMC, BAC, Citi, also Merrill, Lehman, before – every transaction they enter with a customer they keep as a bilateral trade. They are the central counterparty to tens of thousands of customers. They have significant mark-to-market exposure. Their objective is to profitably make markets.
  + [Cyrus Amir Mokri, CFTC employee:] When individual financial institutions function as central counterparties, if one seems in trouble, there will be a run on the counterparty.
* A clearinghouse needs (1) reliable pricing data and (2) liquidity, so that you can unwind in a crisis. Jamie Dimon said 75-80% of trades can be done on a clearinghouse. We still said the other 20-25% should be allowed but dealers should be regulated for those.
* [Absence of clearinghouse as cause of crisis?] “When you get into the crisis, everyone finally reads through their ISDA Master Agreement and says, I was supposed to be collecting collateral.”