

STATEMENT OF GARY GENSLER
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
FINANCIAL CRISIS INQUIRY COMMISSION

July 1, 2010

Good afternoon Chairman Angelides, Vice Chairman Thomas and members of the Commission. I thank you for inviting me to today's hearing to discuss the history of derivatives regulation and the role that over-the-counter derivatives played in the financial crisis. I also will address the historic legislation currently being debated in Congress that for the first time will bring much-needed comprehensive regulation to the over-the-counter (OTC) derivatives market.

In 2008, the financial system failed. The financial regulatory system failed. Though there were many causes of the 2008 financial crisis, derivatives played a central role. I know that this Commission is considering many contributing factors to the crisis. For example, to what extent did macroeconomic factors and monetary policy play a role in the crisis? What impact did the housing bubble and lax mortgage origination and underwriting practices have in the lead-up to the crisis?

Though these questions are critical, today's hearing is on unregulated over-the-counter derivatives. As Chairman of the Commodity Futures Trading Commission (CFTC), a Commission established decades ago to regulate on-exchange derivatives, I have focused my

testimony on the role the over-the-counter swaps market played in the financial crisis. These products have a net notional value of approximately \$300 trillion in the United States. That is roughly 20 times the size of the American economy.

Past Justifications for Leaving Derivatives out of Regulation

Over-the-counter derivatives, which started to be transacted in the 1980s, have not been regulated in Europe, Asia or North America. Until the reforms being debated this year, I am not aware of any major country that had directly regulated these markets over a nearly 30-year period. I will touch upon five reasons that some have articulated in the past for such a lack of regulation in the over-the-counter derivatives marketplace..

First, it was claimed that the derivatives market was an institutional marketplace, with “sophisticated” traders who did not need the same types of protections that the broader public needs when investing in the securities or futures markets. This was included in a President’s Working Group report in 1999. European regulators held a similar view that sophisticated traders needed less regulation than the broader investing public. For example, the UK’s regulatory approach was different for investment services offered to “sophisticated” investment professionals than the approach for investment services offered to other investors. Derivatives, however, are complex financial instruments. Even the most “sophisticated” parties would benefit from protections in the marketplace. Markets, even amongst institutions, work better

when transparency and market integrity are promoted, protecting against fraud, manipulation and other abuses.

Second, it was claimed that over-the-counter derivatives did not need regulation because the institutions dealing them were already regulated. That, however, proved to be a faulty assumption. The banks that deal derivatives have not been expressly regulated for their derivatives business. Furthermore, there were derivatives dealers that emerged that were affiliates of nonbanks, such as insurance companies or investment banks. These affiliates were at best lightly regulated. For example, though AIG was a regulated insurance company, its derivatives affiliate, called AIG Financial Products, was not subject to any meaningful regulation by prudential regulators or market regulators. Just because a bank, an insurance company or an oil company may be regulated for one line of business does not mean that it also was regulated for all of its risky endeavors.

Third, it was claimed that large, sophisticated financial institutions dealing over-the-counter derivatives, as well as their counterparties, were so expert and self-interested that the markets would discipline themselves. This assumption proved to be false. These “sophisticated” participants had countervailing incentives to assume risks in order to boost revenues. They also were often unable to adequately judge the risks they were assuming due to the complexity and lack of transparency of the instruments they were trading and the counterparty credit risk they were assuming.

Further, as a perverse consequence of the financial bailouts of 2008, many in the markets may assume that dealers – so big, concentrated and interconnected – could be bailed out again if another crisis strikes. This creates a significant moral hazard – a system where “heads” Wall Street wins and “tails” the taxpayers lose once again.

Fourth, some claimed that over-the-counter derivatives were customized and not susceptible to centralized trading or clearing. Whereas a share of a company’s stock is identical to any other share of that company’s stock, derivatives can be much more tailored to meet the particular needs of a particular business. But derivatives have become much more standardized over the last decade and thus more susceptible to central market structures. One Wall Street CEO testified before this Commission in January that as much as 75 to 80 percent of the over-the-counter derivatives marketplace is standard enough to be centrally cleared.

Fifth, it was claimed at least here in the United States that we should not regulate over-the-counter derivatives because they are not regulated in Europe or Asia. If we did, we would somehow push our markets overseas. But after the 2008 financial crisis, there is now broad consensus across borders that we must bring transparency and lower risk through regulation of the global derivatives marketplace. In fact, Japan passed regulatory reform legislation last month. The European Commission will provide legislative language to the European Parliament in the next few months. Just last week in Toronto, the G20 mandated acceleration of swaps transparency and standardization and reaffirmed its commitment to require all standardized over-the-counter derivatives contracts to be cleared and traded on transparent platforms.

Regulatory History of Derivatives

Derivatives have been around since the Civil War, when grain merchants came together to hedge the risk of changes in the price of corn, wheat and other grains on a central exchange. These derivatives are called futures. Nearly 60 years after they first traded, Congress brought Federal regulation to these markets. In the 1930s, the Commodity Exchange Act (CEA), which created the CFTC's predecessor, became law.

From the 1930s until 1980, derivatives and publicly listed securities were subject to comprehensive oversight by federal regulators. This meant that derivatives were traded on regulated exchanges and policed to ensure fair and orderly trading. We refer to these on-exchange derivatives as futures.

Things began to change in 1981 with the first over-the-counter derivative transaction. Instead of trading through exchanges and being cleared through clearinghouses, over-the-counter derivatives are generally transacted bilaterally and are not subject to regulation.

The absence of a regulatory framework for over-the-counter derivatives in the United States was reflected in a combination of the statutory language of the CEA, Congressional

action, CFTC interpretations and policy statements, case law and regulatory practice. For instance, in 1974, Congress introduced the “Treasury Amendment,” which exempted transactions in foreign currencies, government securities, mortgage securities and certain other debt instruments from CFTC regulation.

By the mid to late 1980s, the question of whether or not swaps should be regulated as futures started getting asked. They were initially unregulated as the marketplace was bilateral and highly customized. In 1989, the CFTC issued the *Policy Statement Concerning Swap Transactions*, in which the agency took the position that most swap transactions “were not appropriately regulated” as futures contracts under the CEA.

Congress subsequently addressed the issue of regulating swaps in the Futures Trading Practices Act of 1992 (FTPA). In that legislation, Congress afforded the CFTC broad exemptive authority over swap agreements and certain hybrid bank products. The FTPA Conference Committee noted that it granted the Commission this authority to specifically address the legal status of swaps and the possible exemption of swaps from the CEA. This authority was utilized starting in January 1993, when the CFTC concurrently published separate final rules that generally exempted swap agreements and hybrid instruments from provisions of the CEA. In particular, the January 1993 “Exemption for Certain Swaps Agreements” was relied upon by the market to exempt swap transactions as long as they were between eligible swap participants, were not standardized, had credit as a material term and were individually negotiated.

Later, in April 1993, the Commission issued an “Exemption for Certain Contracts Involving Energy Products,” which exempted various energy swaps from regulation, provided they were between covered commercial participants, individually negotiated and imposed binding delivery obligations upon the parties.

In the 1990s, the over-the-counter derivatives marketplace continued to grow significantly. Swaps started to become more standardized, though – it may be hard to remember now – we still lived in a world where the vast majority of these transactions happened over telephones, on a bilateral basis and had many components of individual negotiation, particularly on credit terms.

By 1998, the Bank for International Settlements estimated the total notional value of outstanding swaps to be approximately \$80 trillion. The notional value of outstanding exchange-traded futures and options at that time was approximately \$13.5 trillion. That year, the CFTC, under the leadership of Brooksley Born, issued a Concept Release on Over-the-Counter Derivatives that stated the agency’s intention to “reexamin[e] its approach to the over-the-counter derivatives market.”

In the Concept Release, the CFTC solicited industry and public input on whether the “regulatory structure applicable to OTC derivatives under the Commission’s regulations should be modified in any way in light of recent developments in the marketplace and to generate

information and data to assist the Commission in assessing this issue.” As a result of the Concept Release being published, regulators, Congress and market participants engaged in a significant policy debate with regard to the swaps market. Some market participants also raised concerns that had been debated in earlier years with regard to legal certainty in the existing swaps market. Congress passed the Commodity Futures Modernization Act (CFMA) in 2000 to, among other things, confirm the then-existing regulatory practice of exempting swaps from regulation.

Looking back now, it is clear to me that we should have done more at that time to protect the American public through aggressive and comprehensive regulation.

Role of Over-the-Counter Derivatives in the Financial Crisis

I believe that derivatives played a central role in the 2008 financial crisis. Some have argued that the role of derivatives is limited to AIG or credit default swaps. I think it is broader than that. I also think we cannot just look to solve the immediate proximate causes of the last crisis. We have to look out across the whole marketplace. Even if AIG and credit default swaps were the leading culprits, I think we need to look into and regulate the entire market. I am going to use my time today to focus on six ways in which I believe over-the-counter derivatives contributed to the financial crisis. I will start with AIG.

AIG

I think most would agree that AIG was one of the causes of the 2008 crisis. Though it was not the only firm at the center of the crisis – we also had Bear Stearns, Lehman Bros. and weak risk management structures at many large banks – American taxpayers were asked to put \$180 billion into AIG. That's \$600 per American. And the problem with AIG was derivatives.

We all now know the story that AIG Financial Products, trading out of London and managed in Connecticut, was not effectively regulated. With AIG's credit ratings downgraded in mid-September 2008, it could no longer access the markets for needed liquidity to post tens of billions of dollars to satisfy collateral calls.

I don't think anybody would disagree that AIG and its derivatives played a central role in the crisis.

Credit Default Swaps and their use in Asset Securitization

I will now discuss credit default swaps more broadly, both in the context of AIG and the broader marketplace. At its peak, the overall CDS marketplace had a notional value of approximately \$60 trillion. That is about four times the amount of goods and services sold in the

American economy each year. In 2007, at its peak, AIG's credit book, which included corporate debt, regulatory capital and multi-sector CDOs, represented an aggregate of \$527 billion notional amount.

For protection sellers like AIG, selling credit default swaps was lucrative in the short term because they could collect payments required under the CDS contracts. However, a credit default swap can quickly turn from a consistent revenue generator into ruinous costs for the seller of protection. This "jump-to-default" payout structure makes it more difficult to manage the risk of credit default swaps. The risks of insuring securities based on packages of subprime mortgages were highly correlated: if one underlying mortgage went bad, there was a substantial probability that the same thing would occur to other mortgages because of regional patterns in housing markets.

This is likely what happened in the case of AIG, as it wrote credit protection on multi-sector collateralized debt obligations (CDOs), which included substantial exposure to the subprime mortgage market, without appropriate assessment of either the risk that it was guaranteeing or the prudential steps it needed to take to provide a cushion against the occurrence of those risks.

Credit default swaps were used as "wraps" for securitized mortgage products. CDOs, for example, were often guaranteed by third-parties, such as AIG, through issuance of credit default

swaps. Investment banks and other packagers of mortgages that wrapped securities with credit protection to sell to investors often reduced their own risk analysis. Investors, believing that the investment was guaranteed by credit protection provided by investment grade companies like AIG (which until 2005 had a AAA rating), were more willing to invest in the securitized products.

As the notional value of CDS went from slightly less than \$10 trillion in 2004 to roughly \$60 trillion at the end of 2007, mortgage-backed securities (MBS) went from roughly \$1.5 trillion in 2004 to its peak of \$3.5 trillion in 2007 before both started a decline. The simultaneous rise and fall of the CDS market and the MBS market reflects the interplay between weak rating agency practices with respect to CDOs, reliance on CDS protection of CDOs by AIG and other insurers, such as Ambac and MBIA, declining mortgage underwriting practices and the failure of banks to do proper due diligence when packaging the mortgages. Ultimately each of these factors helped feed into the housing bubble. Once the housing bubble burst in 2007, mortgage securitization collapsed, the demand for CDS protection proportionately decreased and the writers of CDS, like AIG, started suffering significant losses.

Credit Default Swaps and their use for Regulatory Capital

Another lesson out of AIG relates to their writing of CDS to banks seeking to lower their regulatory capital charges. Under the Basel capital accords, large banks and investment banks

could significantly decrease their regulatory capital by relying on “credit risk mitigants,” including CDS positions on existing exposures. So, a bank can essentially rent another institution’s credit rating to reduce its required capital.

AIG’s regulatory capital portfolio was more than 70 percent of its total credit portfolio and was primarily written to European banks. Though AIG’s regulatory capital portfolio did not precipitate AIG’s losses, it did play a significant role in problems in European banks. As AIG’s ratings were downgraded and subsequently when it had to be bailed out, many European banks needed significantly more capital to meet their requirements.

Interconnectedness

There are lessons out of AIG and the financial crisis that go well beyond credit default swaps. There are lessons about interconnectedness in the financial system, the lack of regulation of derivatives dealers and the lack of transparency in the swaps marketplace. Each of these had some role in the crisis. Their roles may not have been as central as those of AIG or CDS, but that does not lessen the responsibility to regulate them.

Though the futures marketplace has benefited from centralized clearing since the 1890s, OTC derivatives have not had that requirement. The lack of clearing in the swaps marketplace left the financial system interconnected through a web of transactions in the derivatives

marketplace. In 2008, this contributed to uncertainty at the height of the crisis. As concerns of the viability of one firm increased, risk premium had to widen for all other financial firms that may have had exposure to that first entity's problems. AIG provides an example of this interconnectedness. \$60 billion of the first \$90 billion of the AIG bailout flowed through the company to other financial entities.

These events demonstrate how over-the-counter derivatives – initially developed to help manage and lower risk – can actually concentrate and heighten risk in the economy and to the public.

The web of transactions in the swaps markets contrasts with the futures and securities markets, where trades are cleared through well-regulated central counterparties. Clearing through a clearinghouse means that both counterparties are protected from the other counterparty's default. The clearinghouse stands between the dealer and the counterparty. It also exposes the location of risk. Through transparent operation and robust regulation, central clearing has lowered risk and interconnectedness in the futures marketplace.

Derivatives Dealers

Another lesson from the financial crisis was that the entities that made markets in derivatives were ineffectively regulated or sometimes not regulated at all. The derivatives

affiliates of AIG, Lehman Brothers and Bear Stearns had no effective regulation for capital, business conduct standards or recordkeeping. Without such comprehensive regulation, they were relying mostly on their own risk management practices and profit motives to determine how much capital they would have to keep and what other business decisions they would make.

Regulators were not required to adopt and enforce specific and separate capital requirements for a financial firm's derivatives business. Further, without capital requirements, banks took on more risk that was backed up by less capital, adding leverage to the financial system. Ultimately, someone had to post the capital to back up these transactions. In the case of AIG, it was the taxpayers.

Dark Marketplace

Lastly, the OTC marketplace lacks the public market transparency that exists in the futures and securities markets. Since 1981, over-the-counter derivatives have traded out of sight of market regulators and out of sight of the American public. When an entity wants to enter into a swaps transaction, it goes to a bank or another financial firm and gets a price quote.

The buyer and seller never meet in a centralized market. The lack of transparency enables Wall Street to profit from wider spreads between bids and offers. This is in stark

contrast to 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.

Some have legitimately debated whether this lack of transparency was a contributing factor to the financial crisis. I believe that, though it is not as explicit as the failure of AIG, this lack of transparency did leave our financial system more vulnerable. The inability to price many complex mortgage securities created a new word in the public lexicon: “toxic assets.” Such assets were loans and securities held by banks that were too difficult to price because there was no transparent pricing for them or their component parts. A centralized marketplace for derivatives would provide much-needed reference to price other derivatives as well as the “toxic assets” that were often based upon similar underlying risks.

Further, transparency would lower risk in the system by enabling clearinghouses to get reliable pricing information and determine the liquidity of particular contracts. This is essential for clearinghouses to adequately manage their risk.

Current Legislation

The legislation reported by the Conference Committee earlier this week is strong, comprehensive and historic.

The legislation includes strong regulation of over-the-counter derivatives dealers for the first time. This includes both bank dealers on Wall Street and nonbank dealers, such as the next AIG. Dealers will be subject to capital and margin requirements for their derivatives books to lower risk. They will also be required to meet robust business conduct standards. This will promote market integrity by protecting against fraud, manipulation and other abuses. Business conduct standards also lower risk through uniform back office standards for netting, processing and documentation. Dealers will for the first time be required to meet recordkeeping and reporting requirements so that regulators can police the markets.

It is not enough, though, simply to promote transparency to the regulators. The financial reform package that emerged from a conference also makes the over-the-counter derivatives marketplace transparent to the public. Public market transparency greatly improves the functioning of existing securities and futures markets. With this legislation, we will be able to 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 bill accomplishes this by requiring standardized swaps to be traded on regulated exchanges or other trading facilities, called swap execution facilities. 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.

To further lower risk in the system, the legislation requires that standardized derivative be cleared through central clearinghouses. This will bring the same risk-reducing features of the futures marketplace to the swaps marketplace and will lower interconnectedness in the system.

Though the bill includes exemptions from clearing when banks are transacting with their corporate end-user customers, it requires contracts between two financial entities to be submitted for clearing. This will greatly reduce interconnectedness in the financial system as well as the risk of future taxpayer bailouts.

Conclusion

I thank you for inviting me to testify today. I look forward to your questions.