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Sec. Geithner seeks 'right balance' for new derivatives rules

By Jon H. Harsch

Barraged by questions Friday in a joint hearing of the House Agriculture and Financial Services Committees, U.S. Treasury Secretary Timothy Geithner divided his time between answering:

- Republicans who called for a more deliberative approach to rewriting derivatives trading rules and who charged that the administration's stimulus efforts aren't working.
- Democrats concerned that the administration's proposed new rules for derivatives trading don't go far enough to curb market speculation.

With unemployment continuing to climb despite massive stimulus spending, Rep. Bill Posey (R-FL) asked Geithner to explain "Where do you think your plan went wrong?" In response to such concerns, Geithner said that "we have slowed the rate of decline in the economy" and testified that to deal with "the most severe financial crisis in generations," the administration "has taken extraordinary steps to stabilize the economy and to repair the damage to the financial system." He explained that the next necessary step is to "to lay the foundation for a safer, more stable financial system in the future. This financial crisis has exposed a set of core problems with our financial system. The system permitted an excessive build-up of leverage, both outside the banking system and within the banking system." Specifically he said "establishing a comprehensive framework of oversight for the OTC derivative markets is crucial to laying the foundation for a safer, more stable financial system."

Geithner said a major problem was that AIG and other insurance companies "sold huge amounts of credit protection on mortgage-backed securities and other more complex real-estate related securities without the capacity to meet their obligations in an economic downturn." The problem was made worse, he said, "Because of a lack of transparency in the OTC derivatives and related markets, the government and market participants did not have enough information about the location of risk exposures in the system or the extent of the mutual interconnections among large firms. . . The lack of transparency in the OTC derivative markets combined with insufficient regulatory policing powers in those markets left our financial system more vulnerable to fraud and potentially to market manipulation."

Given those problems, Rep. Maxine Waters (D-CA) called on Geithner at the hearing to ban all credit-default swaps. She argued that “Preventing all credit-default swaps is essential to bringing stability to the market and preventing a similar crisis in the future.” Geithner’s response to Waters and other members concerned about continuing problems with derivatives trading was that derivatives serve a valuable service and that what’s needed is proper regulatory oversight to ensure that adequate margins and capital requirements are in place.

Rep. Bob Goodlatte (R-VA), former Chair of the House Agriculture Committee, told Geithner that “this hearing is premature” and warned against rushing legislation through without full deliberation. He called for postponing action until the administration is able to provide “more precise answers” about the details of proposed changes and potential impacts. Rep. Scott Garrett (R-NJ) warned Geithner that “We don’t want to move too soon, we want to be more thoughtful.”

Agriculture Committee Ranking Member Frank Lucas (R-OK) who is also a senior Member of the Financial Services Committee asked Geithner to say how much tougher the administration’s proposed new capital requirements for derivatives trading could be. Lucas and other members warned that raising the costs of necessary risk management could either force companies “out of risk mitigation altogether” or force companies “to manage risk with higher prices, which will ultimately be passed onto consumers.” Geithner’s response was that details such as specific levels of capital requirements are still being worked out. But he told several members that generally he expects savings from moving more risk management to standardized derivatives with central clearing because customized trading tends to be more expensive for companies hedging their risks.

Rep. Mike Rogers (R-AL) said American business has been “devastated economically,” creating a “crisis of confidence, people are scared to death.” He asked Geithner to provide a “timeline” for economic recovery. Geithner replied that “The lesson of financial crisis here in the United States and around the world is when you face a loss of confidence and a loss of demand of this magnitude, when you have a financial system on the edge of collapse, the only path to mitigate the damage is for the government to do what this Congress did and this government did, to try to make sure you are providing support for investment, for targeted tax cuts, to try to get demand going again. That is necessary but not sufficient. It also requires making sure you stabilize the financial system and help get credit flowing again.”

Explaining the administration’s plan for the derivatives market, Geithner said:

> “**First**, we propose to require that all standardized derivative contracts be cleared through well-regulated central counterparties and executed either on regulated exchanges or regulated electronic trade execution systems. . .
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> “**Second**, through capital requirements and other measures, we propose to encourage substantially greater use of standardized OTC derivatives and thereby to facilitate substantial migration of OTC derivatives onto central clearinghouses and exchanges. We will propose a broad definition of ‘standardized’ OTC derivatives that will be capable of evolving with the markets and will be designed to be difficult to evade. . . In addition, we will raise capital and margin requirements for counterparties to all customized and non-centrally cleared OTC derivatives. Given their higher levels of risk, capital requirements for derivative contracts that are not centrally cleared must be set substantially above those for contracts that are centrally cleared.

“**Third**, we propose to require all OTC derivative dealers, and all other major OTC derivative market participants, to be subject to substantial supervision and regulation, including conservative capital requirements; conservative margin requirements; and strong business conduct standards.

“**Fourth**, we propose steps to make the OTC derivative markets fully transparent. Relevant regulators will have access on a confidential basis to the transactions and open positions of individual market participants. The public will have access to aggregated data on open positions and trading volumes.

“**Fifth**, we propose to provide the SEC and CFTC with clear authority for civil enforcement and regulation of fraud, market manipulation, and other abuses in the OTC derivative markets.

“**Sixth**, we will work with the SEC and CFTC to tighten the standards that govern who can participate in the OTC derivative markets. We must zealously guard against the use of inappropriate marketing practices to sell derivatives to unsophisticated individuals, companies, and other parties.

“**Finally**, we will continue to work with our international counterparts to help ensure that our strict and comprehensive regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries.”

Responding to Republican questioning which focused on charges that the economy has deteriorated under the Obama administration, Rep. Leonard Boswell (D-IA) said that 90% of getting well is “thinking you’re getting well.” He said that instead of “trying to pick fault” with the administration’s performance, “Let’s get this country back and shape and let’s do it together.”

To read Secretary Geithner’s prepared testimony for the OTC Derivatives hearing July 10 or watch a webcast of the hearing, go to:
http://www.house.gov/apps/list/hearing/financialsvcs_dem/hrfc_081009.shtml

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