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CFTC Chair Gensler seeks joint US-EC crackdown on derivatives

By Jon H. Harsch

One major objection to U.S. financial regulatory reform is that tightening regulations in the U.S. will drive traders to foreign markets to escape regulation. On Friday in Brussels, U.S. Commodity Futures Trading Commission Chair Gary Gensler answered this concern by appealing directly to the European Commission to match proposed tougher U.S. regulation with equally tough measures in Europe.

In his remarks, Gensler told the Europeans that "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."

Gensler emphasized that last year's AIG collapse made it clear that the problem is international in scope: "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. . . 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."

Gensler said "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."

Echoing what he's called for in testimony in congressional hearings and now calls on Europe to implement, Gensler said that to avoid a repeat global financial crisis:

- "The banks that deal in derivatives should be required to meet capital standards and margin requirements to help lower risk."

- "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."
- ". . . 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."
- ". . . 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."
- "Regulating the dealers is also the only way that we can ensure against having ineffectively regulated institutions, such as AIG, in the future."
- ". . . 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."
- "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."
- ". . . 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."
- ". . . 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."
- ". . . 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."

- " 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."

To read CFTC Chair Gensler's Sept. 25th speech to the European Commission, go to: http://cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opagensler-12.pdf

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