Geithner sees ‘strong consensus’ for regulating OTC derivatives

By Jon H. Harsch

Washington, Dec. 2 – In a Senate Agriculture Committee hearing Wednesday, U.S. Treasury Secretary Timothy Geithner said the Obama administration seeks “strong regulation and transparency for all OTC derivative transactions, regardless of the reference asset, and regardless of whether the derivative is customized or standardized.” He said that with the Senate and House working closely with the administration on comprehensive financial reform legislation, “There is a growing strong consensus about the nature and scope of reforms necessary to make our derivatives markets more transparent, more efficient, more fair, and more stable.”

To prevent a repeat of the recent global financial meltdown, Geithner said the administration’s reform plan also “provides for strong prudential and business conduct supervision and regulation of all OTC derivative dealers and other major participants in the OTC derivative markets.”

In the hearing on “OTC Derivatives Reform and Addressing Systemic Risk,” Committee Chair Blanche Lincoln (D-AR) agreed on the urgent need for “building a new architecture for financial market regulatory reform.” She said the main causes of the financial collapse were “inadequate federal oversight of significant sectors of our financial system, particularly our OTC derivatives trading” combined with “a failure to use existing authorities to their fullest extent.”

Lincoln stressed that “I am not about stifling market growth, market innovation or legitimate business activity in any way . . . nor do I have any interest in shipping this important economic engine overseas.” But she added that “a certain amount of market re-engineering will be in order as a result of changes in financial market oversight. To address systemic risk and ensure fully transparent markets, we will have to speak to issues relating to the scope of mandatory clearing, the definition of standardization, segregation of collateral, open access, enhanced capital and margin requirements, resolution authority and conflicts of interest, just to name a few.”

One key issue is mandatory central clearing for the great majority of derivatives trading. That’s a major concern for Republican members of the committee who warn that this threat has already driven some trading overseas and, if enacted, would drive up costs for end users. The committee’s Ranking Member Saxby Chambliss (R-GA) told Geithner that “many end users of derivatives who are not contributing to the systemic risk do not wish to endure the expense of clearing and have asked for an exemption from any such mandate.”

Geithner responded to these concerns by explaining that while there will continue to be a need for customized transactions, subject to higher capital and margin requirements, “all derivative contracts that are liquid and standardized should be cleared through well-regulated central counterparties.” He added that “We also should require that regulators carefully police any attempts by market participants to use spurious customization to avoid central clearing.”

Geithner said that the shadowy world of the $700 trillion unregulated derivates market in 2008 magnified financial problems because “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.”

To prevent a recurrence of such cascading problems, Geithner said central clearing is key since “sufficiently liquid and standardized OTC derivatives will reduce risks to those on both sides of a derivative transaction and make the market more stable. With careful supervision and regulation of the margin and other risk management practices of clearinghouses, central clearing of a substantial proportion of OTC derivatives should help to reduce risks arising from the web of bilateral interconnections among our major financial institutions. This should reduce the prospect of threats to financial stability emerging from the derivative markets.”

Addressing the thorny question of who should decide which transactions must be cleared, Geithner called for a dual-track solution: “We should employ a presumption that a derivative contract that is accepted for clearing by one or more clearinghouses, and approved by the Commodity Futures Trading Commission (CFTC) or Securities and Exchange Commission (SEC), must be centrally cleared by all. But we should not rely exclusively on decisions by the private sector to determine the scope of the central clearing requirement. It is imperative that the CFTC and the SEC also have authority to proactively require central clearing of derivative types that are sufficiently standardized and liquid or whose economic terms are substantially the same as contracts that are centrally cleared – regardless of whether a clearinghouse would accept the derivative type for clearing today.”

Geithner concluded that the administration’s dual-track approach “takes advantage of the expertise of private clearinghouses even as it protects the government from abuse at the hands of rogue clearinghouses that are imprudently seeking new business, or strategic decisions by clearinghouses that are seeking to keep the derivatives markets over-the-counter for the benefit of their owners.”

To encourage more users to opt for clearing, Geithner said that “we should use capital and margin requirements and other measures to provide market participants with incentives to make substantially greater use of centrally cleared derivatives, and thus produce a substantial migration of OTC derivatives onto central clearinghouses. Specifically, capital and margin requirements for non-centrally cleared OTC derivatives should be increased. Given the higher risk they pose, capital requirements for derivative contracts that are not centrally cleared should be set substantially above those for contracts that are centrally cleared.”

Geithner finished his remarks by warning that “the longer we wait, the harder it’s going to be. The forces who always fight reform will have better capacity to fight it because the memory of the damage caused will fade.”

For other news stories, go to: www.agri-pulse.com.

#30