CFTC Chair Gensler calls for regulating OTC market to protect both taxpayers and derivatives users

By Jon H. Harsch

Washington, Jan. 7 – In order to protect American taxpayers from having to spend billions once again to bail out overleveraged financial institutions, Commodity Futures Trading Commission (CFTC) Chair Gary Gensler is calling for “regulatory reform to promote transparency and reduce risk” in the $300 trillion over-the-counter (OTC) derivatives market.

Gensler told the Council on Foreign Relations in New York Wednesday that as long as the OTC market remains opaque and dominated by dealers rather than federally regulated, there will be “significant risk in the system, risk that a year ago was borne by the taxpayers in the form of the largest financial bailout in history.” He said that “While the recent crisis seems to have eased and many banks are repaying TARP money, I believe that we still must enact regulatory reform to promote transparency and reduce risk in the evolving over-the-counter derivatives markets. . . the time has come to bring the benefits of a central marketplace that lowers risk and allows market participants to see how contracts are priced.”

With Congress considering administration-supported legislation to regulate derivatives, Gensler said that “Some opponents of reform argue that derivatives were not at the center of the crisis and should thus not be regulated. I believe, however, that over-the-counter derivatives were at the heart of the crisis. We have all witnessed firsthand the effects that unregulated derivatives had across the entire economy. Everybody in this room put money into a single company that was so interconnected with other financial institutions that its failure threatened the entire system. $180 billion of taxpayer money went into AIG. That’s about $600 from each person in this room.”

Gensler called for three essential components of derivatives regulation:

First, regulating derivates trading because, as in the case of Lehman Brothers and AIG, “Even though derivatives were traded inside a regulated bank, the banks were not regulated explicitly for their derivatives trading.”

Second, "regulatory reform must bring sunshine to the opaque over-the-counter derivatives markets. Over-the-counter derivatives are traded out of sight of federal regulators and out of sight of market participants. This was at the core of the financial crisis. We all recall in the midst of the crisis the inability to price particular mortgage derivatives. The public learned a new term – 'toxic assets' – assets held by banks that were too difficult to price. Bringing transparency to the over-the-counter derivatives markets shifts the information advantage from a small group of derivative dealers on Wall Street to the broader market. This not only benefits end-users, but increases competition in the markets by lowering the barriers to entry for additional market makers and liquidity providers. A greater number of market makers also lowers risk to the system and provides greater liquidity."

Third, "to reduce interconnectedness in the system, standard over-the-counter derivative transactions should be moved into well-regulated clearinghouses. In the over-the-counter derivatives markets, trades are left on the books of the dealers after they are transacted. An interest rate derivative, for example, could stay on a dealer's books for many years. As markets move, the value of those transactions change, but interconnectedness remains. The crisis showed how this interconnectedness concentrates and heightens risk to the American public. Clearinghouses act as a middleman between two parties in an over-the-counter derivative transaction after the trade is arranged. They require derivatives dealers to post collateral so that if one party fails, its failure does not harm its counterparties and reverberate throughout the financial system. It is essential that we reduce this risk in the system. Otherwise, we could see a repeat of the financial crisis as the risk is externalized and the taxpayers are left on the hook."

Gensler acknowledged that "improving transparency and lowering risk would mean big changes for Wall Street. We would move standardized over-the-counter derivatives out of a dealer-dominated market and into a centralized marketplace." But he concluded that "Wall Street's interests are not always the same as the American public's interests."

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