



Commodity Futures Trading Commission

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Keynote Address

Keynote Address of Chairman Gary Gensler, OTC Derivatives Reform, Markit's Outlook for OTC Derivatives Markets Conference

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Good afternoon. It's good to be with you today to discuss much-needed regulatory reform of the over-the-counter derivatives markets. In particular, I will focus on credit default swaps (CDS), products that directly contributed to the financial crisis.

Characteristics of Credit Default Swaps

The market for credit default swaps has grown exponentially within the last decade. According to the International Swaps and Derivatives Association's historical survey of the size of the CDS market, the marketplace grew from a notional value of around \$630 billion in the second half of 2001 to \$36 trillion by the end of last year. That's equivalent to roughly two and a half times the amount of goods and services sold in the American economy annually. Bank for International Settlements data indicates that more than 95 percent of credit default swap transactions are between financial institutions.

The 2008 financial crisis had many chapters, but credit default swaps played a lead role throughout the story. They were at the core of the \$180 billion bailout of AIG. The reliance on CDS, enabled by the Basel II capital accords, allowed many banks to lower regulatory capital requirements to what proved to be dangerously low levels. They also contributed to weak underwriting standards, particularly for asset securitizations, when investors and Wall Street allowed CDS to stand in for prudent credit analysis.

Credit default swaps have many characteristics similar to other over-the-counter derivatives. They are used to hedge risk, and their value is based on a reference entity. They also have characteristics that distinguish them from other derivatives. While the value of interest rate or commodity derivatives generally adjusts continuously based on the price of a referenced asset or rate, credit default swaps operate more like binary options. A seller of CDS could one month collect its regular premium with little expectation that the insured company may default and in the next month be on the hook

for billions if the insured company goes bankrupt. 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. Credit default swaps also have characteristics similar to bond insurance issued by mono-line insurance providers. Further, credit default swaps based upon a single company relate directly to that company’s capital formation and to the price of their equities, bonds and other securities.

Over-the-Counter Derivatives Reform

Credit default swaps have unique characteristics and played a central role in the financial crisis, but we also must bring comprehensive reform to the rest of the over-the-counter derivatives marketplace. The recent chill winds blowing through Europe, including the discovery that derivatives were used to help mask Greece’s fiscal health, are reminders of the pressing need for comprehensive regulation. The 2008 financial crisis demonstrated how over-the-counter derivatives – initially developed to help manage and lower risk – can actually concentrate and heighten risk in the economy.

A comprehensive regulatory framework governing over-the-counter derivatives should apply to all dealers and all derivatives, no matter where traded or marketed. It should include interest rate swaps, currency swaps, foreign exchange swaps, commodity swaps, equity swaps, credit default swaps and any new product that might be developed in the future. Effective reform of the marketplace requires three critical components:

First, we must explicitly regulate derivatives dealers. They should be required to have sufficient capital and to post collateral on transactions to protect the public from bearing the costs if dealers fail. Dealers should be required to meet robust standards to protect market integrity and lower risk and should be subject to stringent record-keeping requirements.

Second, to promote public transparency, standard over-the-counter derivatives should be traded on exchanges or other trading platforms. The more transparent a marketplace, the more liquid it is, the more competitive it is and the lower the costs for companies that use derivatives to hedge risk. Transparency brings better pricing and lowers risk for all parties to a derivatives transaction. During the financial crisis, Wall Street and the Federal Government had no price reference for particular assets – assets that we began to call “toxic.” Financial reform will be incomplete if we do not achieve public market transparency.

Third, to lower risk further, standard OTC derivatives should be brought to clearinghouses. Clearinghouses act as middlemen between two parties to a transaction and guarantee the obligations of both parties. With their use, transactions with counterparties can be moved off the books of financial institutions that may have become both “too big to fail” and “too interconnected to fail.” Centralized clearing has helped to lower risk in futures markets for more than a century.

Regulation of Credit Default Swaps

Regulating derivatives dealers and requiring transparent trading and central clearing of standardized derivatives would greatly reduce risk in the credit default swap market. Additional reforms, however, should be considered to address the unique characteristics of the products. The CFTC is very fortunate to have a strong working relationship with the Securities and Exchange Commission (SEC). Under the Administration's regulatory reform proposal, both agencies have a role to play, consistent with longstanding precedent, in regulating the CDS markets. The SEC would take the lead on single-issuer and narrow-based CDS, and the CFTC would take the lead on broad-based products. While the views expressed in this speech are my own, we are closely consulting with the SEC on appropriate regulatory reform of credit default swaps and the broader over-the-counter marketplace.

Market Manipulation

The CFTC and the SEC should have clear authority to police the over-the-counter derivatives markets for fraud, manipulation and other abuses. It is important that these markets serve to help people hedge risk as well as provide for efficient and transparent price discovery markets.

At the height of the crisis in the fall of 2008, stock prices, particularly of financial companies, were in a free fall. Some observers believe that CDS figured into that decline. They contend that, as buyers of credit default swaps had an incentive to see a company fail, they may have engaged in market activity to help undermine an underlying company's prospects. This analysis has led some observers to suggest that credit default swap trading should be restricted or even prohibited when the protection buyer does not have an underlying interest.

Though credit default swaps have existed for only a relatively short period of time, the debate they evoke has parallels to debates as far back as 18th Century England over insurance and the role of speculators. English insurance underwriters in the 1700s often sold insurance on ships to individuals who did not own the vessels or their cargo. The practice was said to create an incentive to buy protection and then seek to destroy the insured property. It should come as no surprise that seaworthy ships began sinking. In 1746, the English Parliament enacted the Statute of George II, which recognized that "a mischievous kind of gaming or wagering" had caused "great numbers of ships, with their cargoes, [to] have . . . been fraudulently lost and destroyed." The statute established that protection for shipping risks not supported by an interest in the underlying vessel would be "null and void to all intents and purposes."

For a time, however, it remained legal to buy insurance on another person's life in England. It took another 28 years and a new king, King George III, before Parliament banned insuring a life without an insurable interest.

The debate over the role of speculators in markets did not end in the 18th century. That debate continued as the CFTC's predecessor and the SEC were set up following an earlier crisis and that debate continues on to this day. In the case of futures, Congress determined that speculators should be able to meet hedgers in a centralized marketplace. In the oil market, for example, a speculator that will neither produce nor

purchase oil is able to buy or sell oil futures. But Congress did require that all such futures trading be regulated, that markets be protected against fraud and manipulation and that regulators be authorized to limit the size of the position that a speculator can take.

The Administration has recommended – and the House financial regulatory reform bill that passed in December includes – critical steps to address the use of CDS to manipulate markets or possibly commit other abuses. With regard to single-issuer CDS or narrow-based CDS, the SEC should have consistent authority over all financial instruments subject to its jurisdiction. The SEC should have the same general anti-fraud and anti-manipulation rulemaking authority with respect to credit default swaps under its jurisdiction as it has with regard to all securities and securities derivatives under its jurisdiction. In addition, the SEC should have authority to set position limits in single-issuer and narrow-based CDS markets as it now has for other single-issuer or narrow-based securities derivatives. The House bill allows the SEC to aggregate and limit positions with respect to an underlying entity across markets, including options, equity securities, debt and single-stock futures markets.

Bankruptcy

Credit default swaps also can play a significant role once a company has defaulted or gone into bankruptcy. Bondholders and creditors who have CDS protection that exceeds their actual credit exposure may thus benefit more from the underlying company's bankruptcy than if the underlying company succeeds. These parties, sometimes called "empty creditors," might have an incentive to force a company into default or bankruptcy. These so-called empty creditors also have different economic interests once a company defaults than other creditors who are not CDS holders.

These incentives result from the separation of economic risk from beneficial ownership. In the capital markets, assuming economic risk usually comes with some type of governance right. Shareholders place their investment at risk, which brings the right to vote and to inspect books and records. Debtholders may extend credit or buy bonds along with rights as outlined in various debt covenants and indentures, as well as having rights in bankruptcy court.

Though reform efforts to date have yet to address the bankruptcy laws, we should seriously consider modifications to address this new development in capital markets. One possible reform would be to require CDS-protected creditors of bankrupt companies to disclose their positions. Another is to specifically authorize bankruptcy judges to restrict or limit the participation of "empty creditors" in bankruptcy proceedings.

Adequate Capital and Risk Management

Credit default swaps also play a significant role in how banks manage their regulatory capital requirements. Under the Basel II 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. U.S. standards under the Advanced Capital Adequacy Framework, though more conservative on this matter than Basel II implementation elsewhere, also allows for some reduction of regulatory capital

when a bank purchased CDS protection from an eligible entity. So, a bank can essentially rent another institution's credit rating to reduce its required capital.

Two lessons emerge from the role of CDS in this context. First, bank capital regulation should be modified to make the use of CDS for capital reduction more restrictive. For example, possibly only CDS subject to collateral requirements could be allowed to provide capital relief, or a bank's exposure to particular CDS protection sellers could be limited. These measures are within the current regulatory authority of bank regulators, and I am hopeful that internationally coordinated and consistent revisions to the capital adequacy regime that are currently underway will consider such suggestions.

Second, as credit default swaps played such a central role across the financial industry failure of 2008, I believe to the extent Congress were to have any end-user exemption from trading or clearing, there should be no such exemption for CDS products. Fully 95 percent of this market is between financial institutions.

Asset Securitization

Lastly, credit default swaps also played a significant role in how mortgage and other asset securitizations were done leading up to the crisis. Though CDS at first was promoted as an important market innovation, their development ultimately contributed to lower underwriting standards. Investment banks and other packagers of mortgages wrapping securities with credit protection for sale to investors could reduce their efforts in analyzing the risk that due diligence would otherwise require. The crisis certainly shows the disastrous effects of investors and underwriters relying far too heavily on this protection. It is important that reform enable the CFTC and SEC to write rules to establish recordkeeping and reporting rules as well as business conduct standards to help address these risks.

Closing

We need broad regulatory reform of over-the-counter derivatives to best lower risk and promote transparency in the marketplace. While similar to other derivatives, credit default swaps have unique features that require additional consideration. Only with comprehensive reform can we be sure to fully protect the American public.