United States of America

Financial Crisis Inquiry Commission

INTERVIEW OF

GARY GENSLER

Friday, May 14, 2010

***** Confidential *****

Financial Crisis Inquiry Commission

Friday, May 14, 2010

--o0o--

MR. SEEFER: Thank you very much for taking the time --

MR. GENSLER: You're the diagnosis commission, right?

MR. SEEFER: -- to talk to us.

The diagnosis commission?

What are the contributing causes to the financial crisis, that is our charge by the statute that was passed last year. And as I told Tim, who I suspect told you, one of the areas we're looking at now in depth is the role of derivatives in the financial crisis, the role of regulation or lack thereof of derivatives, and whether or not that contributed to the financial crisis; and, of course, who better to talk to about that than the Chairman of the CFTC.

So that's why we wanted to talk to you. And I will tell you what I have been doing with folks like you, is really just asking the broad-based question in the beginning, and then following up. And that is, to get your opinions on what role, if any, derivatives played in either contributing to the financial crisis or acting as a propagating mechanism; what the role of regulation or lack thereof was; and since you are chairman of the CFTC, what role regulation should be playing now, since I know you guys are involved and have a little legislation going on right now.

MR. GENSLER: Okay, and you want me to do that in 30 minutes, or in seven minutes or less?

MR. SEEFER: Yes, so we can follow up.

MR. GENSLER: And I noticed the tape recorder. So I'm on the record, and this is -- does this transcript go -- is this -- I mean, I always have to just always check because I'm a public figure. What is -- is this a transcript for --

MR. SEEFER: This is a transcript primarily for the record, for the commissioners who, a lot of them, like to listen to this. It can be designated "confidential," if you would like it to be designated confidential, and you can get copy of it, if you would like to get copy of it.

MR. GENSLER: No, I just need to know. I mean, if it's a public thing for the record, I should have had Scott here, too –- then I just know I'm on the record. And I'll just find my words more thoughtfully.

MR. SEEFER: Yes, it is an on-the-record interview.

MR. GENSLER: On-the-record, public transcript interview.

MR. SEEFER: Well, we’re not going to make it public if you want to designate it ”confidential,” unless the commissioners decide to make it public. And if they decide to make it public after somebody deems it confidential, we give notice to those folks, and hear if they have any objections. And they take that seriously. And it requires you, chair, and vice-chair to agree or for the majority of the Commission to --

MR. GENSLER: What do most people do that you’ve been interviewing? What’s your standard operating procedure?

MR. SEEFER: The standard operating procedure is, most folks have not said, “I want this designated confidential.” Some have, and we’ve said, “Fine.”

MR. GENSLER: Public, just the nature of my answers, I have to think a little bit more.

I think the financial system failed America. I think the regulatory system failed. It’s not one or the other, to me.

I think the work of your commission is really important.

I think derivatives played a role. I think that wasn't the only factor. And I'll quickly touch upon some of the other factors.

No doubt, you're studying, you're well into the weed of. But then I'll talk about derivatives as long and as in depth as you want. But I think that we have, as a nation, very significant economic imbalances. You know, we went into this period of time with low and declining savings rates. And these are global imbalances. Very high savings rates in Asia, particularly in China and in the Middle East.

I think we left the nineties with an asset bubble in the securities market that -- usually asset bubbles, not always, are a sign of imbalances in your whole economy; but that that -- not directly, but we sort of moved into an asset bubble in the real-estate market, both residential and commercial.

I think a contributing factor, though there's great debate on it, is the low interest rates at the Federal Reserve, the very easy monetary policies of the early decade.

I appreciate and respect there are others that debate that and have a different view on it.

But these global imbalances -- you know, the evidence of it, very low savings rates, significant trade imbalances, of course, moving from budget surpluses to budget deficits.

And you can see it also in the markets, the credit spreads, the spread that is being charged in markets for risk. It's basically a risk premium, where it was diminishing. The risk premium crossed a number of years in the mid-decade that kept -- whether it's measured in swap spreads, corporate bond spreads, the pricing of junk bonds at risk premium. Now, risk is always within society -- risk is always within markets. But we had an asset bubble that also moved into the commodity markets, which is something the CFDC oversees -- you know, the commodity markets.

A second factor well beyond those global imbalances, I think, is -- I'll just hit a few, I think -- and I'm sure you're studying every one of these -- but the mortgage underwriting practices and the whole pipeline, from the -- we took a look at this when I was in the Clinton Administration in 2000, to Andrew Cuomo's credit and Larry Sommers was then Treasury Secretary, I was asked to work with Andrew Cuomo. Michael Barr and I were to work with him. And we went around the country and we sort of studied what was then called "predatory lending." It seems like it picked up a different name later, "subprime lending."

And we put out a report -- the Treasury and HUD put out a report in the spring of 2000 that had a series of recommendations about subprime lending, which was about predatory lending. Ned Gramlich at the Federal Reserve, was very helpful.

I remember testifying with Ken Apgar of the FHA on a series of recommendations. They lasted on Capitol Hill a very short time. I mean, there wasn't much appetite or mood to take these recommendations. And even the recommendations at the Federal Reserve itself could do, the Federal Reserve didn't do. It was around -- what was that law, HOEPA and the protections you could have.

I'm not suggesting that if everybody listened to the joint Treasury-HUD study in 2000, we wouldn't have had this crisis. But I'm just saying, these are -- these issues in the subprime marketplace, in some regards, the poor -- the poor selling practices were known.

Down the chain, the underwriting practices were starting to reveal themselves; but I think by the mid-decade, you had a lot of changes, and there was a lot of practices –- really bad practices in the chain.

Starts with the mortgage finance companies, many of them weren't federally regulated. I think we have a very patchwork-quilt sort of environment for regulation.

Most -- not all, but most of the firms that came into trouble weren't even federally regulated in the mortgage -- in the origination chain.

But it goes all the way through the underwriting practices, all the way out to the main Wall Street firms, as to how they were…

So that gets to my next areas, the rating agencies. I think they're gatekeepers. The gatekeeper function of underwriting, the gatekeeper function of rating agencies I think very much broke down. And I'm not even -- I'm not even suggesting it's a lack of regulation. I mean, I just think -- and the rating agencies had, for decades, rated basically corporate bonds and state municipal bonds. But by the late nineties, you started to have these new, structured deals. There was a whole opportunity for the rating agencies to grow and to build upon and to compete.

The model was very much underwriter-directed, picking your rating agency. And you didn't have to pick three of them. Like most corporations actually get two or three ratings. So interestingly, the rating agencies didn't necessarily have to compete as much. But I think in this structured-product area, the rating agencies were very -- they very much were remiss in their gate -- sort of what I call the “gatekeeper function,” the critical review of these things.

So it was a little bit part -- not “a little bit.” I think that’s a key factor.

There’s a whole bunch of other things that I’ll mention before I do derivatives, which I’m doing shortly.

We didn’t have consolidated supervision of complex financial institutions. This was something that was known, even, in the nineteen-nineties. I mean, Europe -- as Europe went to the concept of consolidated supervision, they would raise it with U.S. regulators. All right, you’ve got the -- there’s a Holding Company Act that came out of the 1950s. So banks, when they started to have multiple banks -- you know, you might at first have multiple banks in the same state; and then by the 1970s and 1980s -- I guess 1980s you start to have them cross-states. The concept of a holding company, so the Federal Reserve was that.

But when the investment banks started to do affiliate structures, you had the SEC regulating the broker/dealer, but nobody technically had regulation of their affiliates.

You’ve probably studied the -- what’s that, CSE program over at the SEC?

MR. SEEFER: Yes.

MR. GENSLER: But there was no effective consolidated supervision of the investment banks. There was no effective consolidated supervision of anything that had an OTS label on it.

I mean, I think -- so AIG fell into that category.

So I think that's another -- that was a real gap in the system, consolidated. And that means consolidated capital, consolidated risk management across the whole platforms.

I think the capital standards themselves played a role in this; that partly in Europe, BASEL III, I think, left a lot of holes, but CSE program –- BASEL II, I'm sorry -- that the CSE program picked up the capital standards of BASEL II as well -- you know, the risk management approach there. And it plays into derivatives, which I'm going to hold a little bit on, but I think that's part, the capital standards.

And then the last thing I'm going to mention before I talk to derivatives, I think modern finance, and probably finance of the future, will never repeal the tendency of a crowd to all want to get to the door at the same time. Call it the classic "runs on the bank." And that wonderful 1946 movie, "It's a Wonderful Life," George Bailey has his little savings and loans, and all the depositors want to get the money out. And the angel, of course -- you know, we had an angel, you know. We didn't quite have an angel in this scenario but…

The modern run in this crisis you saw in several scenarios, but -- you saw it in money markets, when the reserve fund broke the buck that Wednesday of the fateful week; you saw it in prime brokerage relationships between hedge funds and investment banks, when -- after Lehman failed, there was so much intense, severe pressure on Merrill, Morgan Stanley, and Goldman that the prime brokerage relationships would pull all of the securities out. That's technically pulling out the stock loan and the tri-party repo.

But what I think -- and I don't think we'll repeal that. I think that the tendency to crowds to all want to get through a narrow opening in one moment of crisis, you know, is something that rather than saying we're ever going to repeal that, we have to make sure that we build our financial institutions and regulations to anticipate some of that. The runs on the bank of the George Bailey circumstance is very different now.

But I think what we've failed is, these

institutions, whether it was the largest amongst them -- Citicorp or others -- I think had a fundamental mismatch and a weak appreciation for what happens to liquidity and funding in crisis. And I think that these large financial institutions -- here in the U.S. and in Europe -- had a tremendous, I would say, overreliance on short-term funding that could have been in the money market desk, through tri-party repo, through stock loan, so forth; which, of course, all of that was then getting their money from the mutual-fund industry -- the money market was about $3.6 trillion in money markets.

That -- in a crisis, when that gets pulled, their assets were always illiquid.

Now, some could say, “Listen, that’s what financial intermediation is.” Financial intermediation, at its core, is bringing together people who have money and people that need money, and you stay out of the middle of that. It’s bringing to people that have a risk and want to lay off that risk, and somebody who is willing to bear the risk. You can think of insurance, in a way.

But also financial intermediation is about maturity mismatches. You know, George Bailey has a maturity mismatch. All those depositors give him money, and then he puts it out in 30-year mortgages. The maturity mismatch is something at the core of financial institutions. But I think that the regulators just haven't had enough cushions for liquidity runs. And that many of the assets -- the assets of Lehman Brothers were probably terribly mismarked. That your study of Lehman Brothers would be about a lot of issues about how they did 105 repos and how they put things off balance sheet, and your study of the big banks will be how they put stuff off into special-purpose things called SIVs and so forth. But I also think that on the assets side, they were fundamentally misjudging how illiquid these things were just because they put it inside of a loan.

Lehman Brothers had a lot of things they called commercial loans. Now, if you make a $100 million loan against a building that's worth $105 million, it is a loan, but now the building's worth $95 million, you know, a month or two later, it feels like more like you own the building. So is it real estate or a loan?

And so I think that's my last thing before derivatives.

I could go on. But you guys have a lot of fun. You've got a lot to study.

Derivatives, is this what you guys want me to cover?

MR. SEEFER: Yes, it is.

MR. GENSLER: All right. Over the -- let me just say a little bit of background about derivatives.

Derivatives in our country started in the Civil War. In 1865, just before, I guess, Lee and Grant were meeting in Virginia, some other people were meeting off in -- it's true, that's when it was, it was just a few weeks before they were meeting -- off in Chicago, some grain merchants and millers and everything figured out that to hedge a risk in corn and wheat, they would no longer just enter into what was called a "forward contract."

A "forward contract" would be that sometime, a few months from now, I'll deliver the corn and you'll give me money. Somebody invented what was called a "futures contract." It was that a few months from now, at harvest time, I might deliver the corn and you might give me the money, but I also have a right to financially settle that contract. I don't have to physically deliver. That was the great innovation in 1865 that started the derivatives market.

A futures contract was just that simple somebody planting and growing and milling corn or wheat could protect themselves against the future price of corn or wheat, and would not have to actually, physically deliver the corn or wheat, or not physically take it into their stocks.

It was also a way to discover prices on a more national or regional basis than just what the local, you know, fellow would buy it for.

It took nearly 60 years to first regulate that. In the early 1920s, the Grain Act was passed.

Right, Dan? Do I have that right? It went all the way to the Supreme --

DAN: ’22, ’22.

MR. GENSLER: ’22. It went all the way to the Supreme Court, and then it was declared unconstitutional, actually, because they said it might not have to do with interstate commerce.

Well, they fixed it. They put a couple of different clauses in and they did it again.

The core thing -- and then by 1936, just the same way that Roosevelt went to Congress and said that we had to protect the securities markets against manipulation, Roosevelt went Congress and said, “We have to protect these commodities markets.” But it was fundamentally derivatives markets from manipulation. They were all agricultural commodity derivatives at that time. There was no interest-rate swaps. There was no oil swaps.

But the fundamental things that were done then, was they had to be on transparent exchanges, and it was a mandate. All of them had to be on exchanges. And they give some authority -- our predecessor -- some anti-fraud and anti-manipulation authorities, of course.

And then there was an innovation from the 1890s called, “Clearinghouses.” Clearinghouses are just middle men that stand between a purchaser of a derivative and a seller of a derivative; and on a daily basis, ask for performance money to be posted because they’re valuing that derivative on a daily basis.

This history will be relevant.

So that’s about where it stood. But then you get to the early seventies, and people start to do derivatives on equities. They were called “stock options,” but they were a form of derivative. An option is a form of derivative. And they started to do it on a centralized exchange out in Chicago. And there was this debate how to -- what do we do about that, how do we regulate it and so forth.

And so what came out of that period of time is that our predecessor got pushed out of the agriculture department, got broad, new authorities over all of what was called “futures.”

“Futures” are basically on-exchange

derivatives. So we picked up authority for oil futures and financial futures and so forth.

And by 1980, probably, all derivatives contracts were on exchanges, and the majority were financial by 1980, they were mostly on the equity markets, or they might have just started on the Euro dollar contract in the late seventies, I think.

Well, in 1981, over at Solomon Brothers, somebody brokered a trade between World Bank and IBM on a currency derivative. Or at least the story goes.

MR. SEEFER: Uh-huh.

MR. GENSLER: And the start of what was off-exchange derivatives or unregulated derivatives occurred. They initially were bilateral.

They were initially, actually, brokered. They weren't taken onto the bank's books. But within several years, all the banks said, "We're going to -- this is a line of business. We'll actually take the thing right onto our books." They sort of operated as the central clearer, in a way, without asking for performance money.

They were customized. And, of course, we didn't live in a world where people could walk in with a computer. You know, there were no computers. I'm old enough to remember.

MR. SEEFER: So were we.

MR. GENSLER: Yes. I don’t think your colleague is.

There were debates. There were debates as early as probably ‘87, ‘88. Our agencies got reauthorized every, about five years. There was a big debate in ’92: What do we do about these things now that are called “swaps”? So derivatives are futures and swaps. The on-exchange derivatives fully regulated, and they were called “futures.” These off-exchange derivatives, which were mostly bilateral, customized, not done in any central place, no central clearing, what do we do?

And late in the eighties and by ‘92, there was a growing, sort of pressure from Congress, probably from industry, maybe even from the regulators, that this needed to be addressed.

So in 1992, I guess, in our reauthorization, there was a provision that we’d have an exemption authority. And we were specifically sort of suggested in the committee report, not in the statute, that we use the exemptive authority to exempt this whole class.

And Wendy Gramm was chairman then. And before she left in January of ‘93, she put out the swaps exemption.

There was a swaps policy statement for three or four or five years earlier. We can summarize all this history, but I'm just trying to -- but, I mean, the swaps policy statement, either in the late eighties or early nineties -- do you remember when it was?

MALE VOICE: Late eighties.

MALE VOICE: Late eighties.

MR. GENSLER: Yes, the swaps policy statement in the late eighties, and then the exemption that Congress -- I mean, Congress granted the exemptive authority. So in a sense, Chairman Gramm used the exemptive authority. There was this --

The thinking at the time -- we can look back now and say, "Things should have been done differently," and all that. But the thinking at the time, I think, was -- I captured this in a speech I gave up at Columbia University -- Joe Stiglitz asked me to go up there, and I did this a month or two ago, we could send you that one. But I think -- and even through the late nineties, because I could go through the Brooksley situation, too -- well, let me just go through the history and then I'll give you the thing at the time.

So there's also a really critical moment there, that Brent Crude Oil's thing was about then, too. There was this -- whether a contract was traded on Brent Crude was a future and should be on an exchange. It went into a court situation. The Court said it could be a future, it was a future.

And so one of the other things that happened in ‘93 was, there was also that was exempted here. So there was two things: One under Gramm, but the Brent thing, I think, happened a few months after she left. I can’t remember.

MALE VOICE: The energy exemption was a few months after.

MR. GENSLER: Yes, so the energy exemption was a few months later.

The thing got tested a little bit when Mary was in my job -- Mary Schapiro was in this job in the *Metallgesellschaft* case, she tried to sort of test the outer boundaries, the question -- the legal question was: Were swaps futures? Because our statutory language at the time said futures had to be on exchanges.

It didn’t say “derivatives,” it said “futures.” And so there was a legal question: Are swaps futures?

Everybody knew that swaps and futures were pretty similar, but were they technically futures? That was this legal question.

Throughout the eighties, people said really not. But, you know, as you got into the nineties, they started to have some characteristics.

Wendy Gramm’s swap exemption was, they had to be bilateral; they had to be individually negotiated; they, thirdly, couldn’t be on central clearing.

Let’s see, individually negotiated, bilateral, not cleared.

She had a fourth characteristic.

I don’t know, it’s still in our Part 35. You could find it in Part 35.

So that was the sort of conceptual framework.

Mary sort of tested a little this futures swap things in the *Metallgesellschaft* case. There was a lot of back pressure. The case got settled. Mary went over to NASDAQ, and then Brooksley came.

A critical thing in the history is also the SEC. There was a little bit of turf thing going on with the SEC, too. The SEC did something called “broker lite” in late ‘97, where the investment banks wanted to set up affiliates to do derivatives business. The question is, how do they get regulated? The broker/dealers didn’t want to keep their swaps business in the broker/dealers. They wanted to do, if I can use the term, be capitally efficient, or use capital -- arbitrage, if you wish -- and put it in an affiliate, not in a broker/dealer. And somewhere late in '97, there was something called "broker lite." I can't remember its details. Might be Cyrus remembers the details.

MR. SANATI: Especially, BASEL II, you used internal risk-rating methods --

MR. GENSLER: For that --

MR. SANATI: -- to calculate the requirement for broker/dealer lite. And that enabled them to get a higher credit rating, so that all their counterparties could be -- could treat them as though they were -- if not AA, even higher.

MR. GENSLER: Right, right.

MR. SANATI: So it was capitally efficient, not just for, if you will, Goldman and Morgan and Merrill --

MR. GENSLER: Right, right, right.

MR. SANATI: -- but for the counterparties as well. And I understand part of that motivation.

MR. GENSLER: Right.

MR. SANATI: It was also to get away from BASEL I and get into that internal risk rating of BASEL II where banks --

MR. GENSLER: I think, though, as sometimes happens with regulators, it also then became a little bit of a -- you know, that was an SEC thing, it wasn't a bank thing, it wasn't a CFTC thing. I mean, there's probably a little of that, too.

The banks -– the investment banks and that did -- and this is part of the rating-agency story, too -- started to have swaps affiliates that they would then go out and work with the rating agencies to get credit ratings on, to try to do triple -- they were single-A -- they were single-A -- Goldman, Morgan Stanley and so forth were single-A, but they tried to get their affiliate to be triple A or double A, at least, where they would do credit enhancements and they'd work with the rating agencies, highly negotiated to get those swaps affiliates.

I think the missed opportunity -- and we raised it in 1980, after long-term capital management fell in '98, I guess it was in the spring of '99, the Treasury and the President's working group did a report on long-term capital management. And it was basically a report on excess leverage and how to deal with -- I guess the report's name was, "How to deal with highly leveraged institutions." It had a series of recommendations, some of which related to markets and bank regulation but some related to Congress. One of them was that we needed enhanced regulation of these swaps affiliates.

There was a footnote in the report, because Greenspan and Rubin didn't agree on this. I remember because I had to personally negotiate between the two of them as a staffer -- I mean, I was an assistant secretary, but I was like taking each of their language and trying to get the footnote at the time.

So the issue of regulating the swaps affiliates was known in that report. In the spring of '99, it was recommended with basically a -- whatever you want to call it, a lack of concurrence from Greenspan. But it was sort of -- it's buried in a footnote, the lack of concurrence.

And then this agency, under Brooksley's leadership, put out the concept release in the spring of '98. You all know that history well.

It kicked up the same legal question: Are swaps futures? Are futures derivatives? You know, that whole -- it was in the context that Europe didn't regulate derivatives and Asia didn't regulate derivatives. But it was in that context.

And then the Commodities Futures Modernization Act, which I'm not -- you know, I mean, I could go through, but you kind of have --

MR. SEEFER: Uh-huh.

MR. GENSLER: But I think the five things -- and Scott could send you the thing because Scott helps me in all my speeches and he’s our -- he runs the press area -- the five things as to why, I think –- and these are just my views, these aren’t the CFTC views – but I think the five areas that I think of that why, over these decades, why Europe, Asia, and the U.S. didn’t bring this under regulation, because it’s not just here.

MR. SEEFER: Uh-huh.

MR. GENSLER: I think that, first, there are three somewhat intertwined assumptions, but let me see if I can remember them without the speech in front of me.

One assumption was that the parties to these contracts were all sort of sophisticated parties. Big girls, big boys -- you know, large enough to fend for themselves.

Two, was that the institutions that were operating as dealers, what we are now calling “swap dealers,” were basically regulated, anyway.

And, three, that somehow that market discipline amongst these sophisticated parties with the institutions generally regulated, anyway, would kind of work.

That third one is sometimes associated with

Chairman Greenspan; but, I mean…

The first assumption, that they're all sort of large, sophisticated actors, and so do they need protections, I think sort of, in a sense, has proven out to ignore that there's larger, broader, more, you know, systemic implications, even if you're saying -- even if you believed -- and I'm not saying I do -- but even if you believed there wasn't a need to, you know, protect individual actors.

We're -- actually, this gets into our recommendations. We're proposing -- and it looks like we may be able to be successful in this -- that the SEC and CFTC have explicit role-writing authority to protect business conduct, protect business conduct from fraud, manipulation, and other abuses in this marketplace. But that would have been unheard of through this debate, that this sophisticated marketplace should have such protections of fraud, manipulation, and other abuses.

This second assumption, that kind of these actors were well, kind of regulated, anyway, and I would say even looking back, because I was part of the Clinton Administration, though I was recused during the year with Brooksley and my boss, the Secretary was having that sort of thing -- because I was just in my first year from Goldman Sachs -- I would say that I was probably prone to this false assumption, too -- the second assumption, is that the large dealers were regulated.

Where that breaks down is, it wasn't really true for a lot of them. The affiliates of the investment banks, the AIG affiliate, they weren't really effectively regulated.

And even if you were in the middle of a bank, even if you were in the middle of a large bank and you were regulated by the bank regulators, you weren't explicitly regulated for capital.

To this day, there is no -- you cannot go to the OCC or the Federal Reserve or BALS *[phonetic]* Web site and say, "Where is the capital rules just for your swap business?" It's sort of like -- it's embedded in everything else. It's not explicit.

There's not explicit rules about how to do netting and back-office documentation, and so forth.

But certainly, as the case of AIG proves in spades, there was no effective consolidated holding company regulation and, thus, there was no effective regulation of its derivative affiliate. There was no -- I would contend, no effective consolidated holding-company regulation of the investment banks.

The CSE program didn't really -- I mean, it was better than what was before, maybe; that there was somebody looking into the affiliates, but very light, apparently.

The third assumption -- I never really believed much in but, you know, there's too many externalities, there's just too many externalities to leave it to chance.

The fourth and fifth thing that I think of is, there was always this sort of thing that these are ––

[Cell phone buzzing]

MR. GENSLER: -- these are -- these markets are highly -- these -- I'm sorry, these hedging transactions are highly customized and bilateral. That was absolutely the case in 1981.

That may have still been the case in 1993 -- in January of '93, when Chairman Gramm put out this swaps exemption.

[Cell phone buzzing]

MR. GENSLER: My problem is, it's my daughter. So let me just do this for a second, I think.

[Off-the-record conversation on cell phone in background and simultaneous off-the-record discussion between FCIC staff]

MR. GENSLER: I'm sorry.

MR. SEEFER: That's okay.

MR. GENSLER: I'm a single dad, so like every time they call, I pick up.

The other assumption was that they're bilateral, they're basically highly tailored, they're not susceptible to centralized market structures. I think that's something that was probably way true in the eighties, it became less true in the nineties, it became a lot less true once computerization took off.

You know, in 1993, when Chairman Gramm put out the thing, there was really no Internet. I mean, you could sort of go do the statistics.

And even in the late nineties, there was no electronic trading. I mean, the New York Stock Exchange was still very much a specialist system, the derivatives markets in Chicago and New York, what we call the Chicago Mercantile Exchange and the New York -- and NYMEX were in the pits, were on the floor.

And in the late nineties, you just started in '98 and '99 to have a little bit of this starting. The Commodities Futures Modernization Act provided some provisions. It was meant to sort of capture some of those emerging issues. Some of them didn't take off.

There was something called DTEFs put into that. But Jeff Sprecher started ICE as an exempt commercial market. But it was just beginning that electric platform.

So I think the last ten years there's been a lot of evolution towards centralization. In front of your commission, Jamie Dimon was asked by Brooksley Borne what percentage of the market could be brought to central clearing, and he said, in January, 75 to 80 percent.

I want to thank you all for having that question, because I quote that often now in speeches.

He's -- I've seen him since then at one meeting; and he said, "Well, maybe 70 to 80 percent. But he still -- the point being that that would not have been the answer ten years ago, and certainly 20 years ago. That the standardization in this market has -- and whatever the standardization, whatever the number is, it's far greater today than it was before.

And the last thing that I think was of debate about why these should be regulated and not regulated and so forth is, "Well, we can't do it here. Well, I'll go overseas." You know, sort of that whole thing, which is -- listen, that's a real, live issue at all times. It's even in what we're doing right now.

We have a remarkable confluence of views between Europe and the U.S. I think we have very good views between the U.S. and Mexico and Canada and Tokyo.

We've been sort of walking this derivatives legislation through internationally. But we still will end up with different cultures and different political systems, with a little variation in this. And there will be some gaps.

But if -- I think that you cannot diminish the influence of this, that these contracts were not regulated in Europe and Asia and anywhere else has even on the mindset here in this country.

So they tell me I have to leave. But you want to know what role derivatives played in the crisis? I think it was a very real role. I think it was a role -- and I'm going to summarize -- but I think -- I think over-the-counter derivatives are important hedging tools for corporate and municipal governments. But they do allow for risks to be concentrated. They're meant to be risk-management tools, and to lower risk for the users, and they generally do that. They don't always do that, but they generally do that. But at the same time that they do -- generally do that for the end users, they have tended to concentrate and heighten risk within this financial institutions.

Financial institutions, when they started this in the eighties, started brokering these transactions but quickly decided to keep them on their books.

MR. SEEFER: Uh-huh.

MR. GENSLER: And as the business grew, they found that very profitable. They charged for the credit extension, because you're extending credit when you're doing these transactions; but they'd also charge for the market-making. They were not moved to central clearing, so the risk stayed within these books.

And in the United States today, there's really five large financial institutions that have the bulk of this business, 95-plus. And you might say there's five to eight overseas.

Now, we could give you a list of 25 swap dealers; but, you know, when you really say where it's a highly concentrated and dealer-dominated business. It's not unusual. The airline industry got concentrated, the auto industry, the drug industry. But this has enormous externalities to it, you know, I think.

And I think it does heighten it and concentrate risk. That's why I'm such an advocate that we mandate central clearing, that we move as much as we can off of the books of these.

AIG, I think, highlighted those risks because when the money went into AIG, the first $90 billion, $60 billion of it went straight through AIG to other counterparties. I mean, it was fulfilling counterparty claims, both on their swaps books and I think on their stock loan. So it's not the first sixty wasn't all because of derivatives.

I think a second thing to consider about how they can heighten it -- so I'm still on my first point of heightening and concentrating risk, but if you want to make it a separate point all together, over-the-counter derivatives can add to the leverage in the system.

"Leverage" is usually thought of as how many dollars of borrowings do you have for every dollar of capital. And that's the classic, you know, first-semester finance answer what "leverage" is. But in the modern world, you can put a lot of that same borrowing, if you wish, in the form of an over-the-counter derivative. And so it can add a great deal of risk.

Long-term capital management, I had the phone call on a Saturday in 1998 to go up to Long-Term Capital Management, the Secretary, then Rubin, asked me to go up. And Peter Fisher from the New York Fed and I went over there. Well, they had a $1.3 trillion derivatives book and they had $100 billion balance sheet. And, of course, not $100 billion of capital. They had about $4 billion of capital.

So the $4 billion of capital in this hedge fund was leveraged 25-to-1. The derivatives book of $1.3 trillion notional amount -- that doesn't necessarily mean that's a leverage ratio. I don't want to misstate people and say, "Oh, my God, that's 200, 300, and 25-to-1." No, it's not that. But you can put so much risk in an off-balance-sheet derivatives book that then is also riding on top of that small. And I think that we saw that, in large measure, of course, at AIG. Less so elsewhere. But I wouldn't diminish that it was elsewhere.

The second big thing about how derivatives played a role in this is in the home-mortgage securitization chain. That whole chain we were talking about earlier. Derivatives and credit default swaps, more specifically, were used in that chain.

Credit default swaps didn't really exist. They were a blip on the screen.

I will tell you, in 2000 -- and I didn't participate in every meeting on this Commodity Futures Modernization Act; it wasn't -- I mean, there was a team of people at the Federal Reserve and the Treasury and the CFTC and the SEC. But the meetings that I was in, I never remember the word "credit default swap" coming up. And what I'm sure of is, nobody ever, like, said, "Let's have a whole meeting on it."

But what I'm saying is, I don't even remember it coming up. It's possible. It's possible somebody would put in front of me a piece of paper that has the words on it, and will my name on it. But it's -- it was such a small part of the market, and it was just starting to happen over at JPMorgan and so forth.

But that product by 2004 and 2005 was being used in a way in this securitization chain that I think had some very adverse effects.

People were effectively trying -- selling their credit rating. AIG was renting for what, in hindsight, was too cheap a premium; but they were renting their AAA rating that they used to have through credit default swaps foremost into these collateralized debt pools, but also to European banks.

European banks -- I don't want to diminish -- European banks had, I think, $300 billion of credit default swaps with AIG. I can't remember. AIG had $450 billion of credit default swaps, and either one-third was to Europe or two-thirds. I just apologize, I can't remember.

MALE VOICE: It was mostly Europe.

MR. GENSLER: So two-thirds. So about $300 billion was to Europe. And the European bank regulators were taking the AIG credit and lowering the capital charges to the European banks.

MR. SEEFER: Uh-huh.

MR. GENSLER: And the effect of it, was that AIG was a house of cards that came down, and you -- and this is part of how it concentrated and heightened risk, is because it's so interconnected, that the financial system at large was so interconnected by all the derivative trades between them.

Clearinghouses can compress all that, can take a lot.

And the first $7 billion of credit default swaps that are now in ICE -- you should interview Jeff Sprecher about this -- but ICE Trust has about seven.

You would think that 7 -- $7 trillion -- I'm sorry, $7 trillion out of the $28 trillion notional is now in ICE Trust. I think they have found, on average, I think he said to me recently, 15 parties when you do the chain. Somebody buys it, somebody sells it, somebody buys it, somebody sells it, somebody buys it.

So when all of this book of business is coming in, they're finding out that the daisy-chain is compressing. And instead of $7 trillion, it's like 1/15th or 1/20th or something -- no, it's well less than a trillion. But it compresses down, I think to like

$500 billion or $600 billion.

You could ask Jeff. He could…

But back to the story. So it heightened and concentrated risk. I think secondly, it was very much a part of this mortgage underwriting chain. Now, you know, it's very topical. I'm sure part of your report will look at synthetic CDOs and so forth. But even if they weren't synthetic CDOs, what was happening is it's like the old bond underwriting thing. I mean, we should know, one of the early signs of this crisis was Bear Stearns' problems, but it was also that MBIA and AMBAC, bond underwriters, they were selling as insurance companies what used to be called in the trade "bond wraps," where they were wrapping their credit rating; they were selling cheap insurance so somebody could get their credit rating.

I can't remember which month in '08, but they went down well before September, right. And that was like -- what's that?

MALE VOICE: January, the New York State Insurance Department had big concerns to everybody together.

MR. GENSLER: Right, right. So there was eight to ten -- MBIA, AMBAC and, obviously, AIG -- but there was like seven to ten others that were basically selling credit default swaps heavily -- they're probably all under now, I don't even know the list. But mostly to this mortgage chain.

But, of course, it's in the context of, you know, an asset bubble. Like if -- but which came first? What created the asset bubble?

You know, and everybody do some of this. But, you know, is it our global imbalances, is it poor underwriting practices, is it credit default swaps, is it poor underwriting standards, where the investment banks were sort of shoveling in and shoveling out? But I think the derivatives paid a very central role to this mortgage underwriting chain through credit derivatives.

I think I'm probably out of time.

What else are we going to say? If they ever ask us to testify, what else am I going to say, Cyrus? Because you're thinking about this, how do derivatives --

MR. SANATI: I think as part of the interconnect of the story is the -- and the opacity of the market contributed to some of the runs that you were talking about. So when a counterparty doesn't know what kind of a derivatives counterparty, their counterparty is involved with, it increases the uncertainty.

MR. GENSLER: The on-exchange derivatives markets futures have had a discipline, really, since the 1890s, but by mandate by law since the 1930s to use central clearing. But clearing has a mandate within itself that every day, the value of the transaction, and the obligation of each of the parties is to send some money. Somebody will send some money, one way or the other.

This marketplace, when it grew up, first in the eighties and nineties, there was no central clearing. There's a little bit of central clearing, voluntary clearing now, but only in the last ten years.

But Cyrus is absolutely right, the interconnectedness is there -- I have to go? -- the interconnectedness is there, but it then has to be coupled with this Cyrus use of fancy lawyer word, "opacity." I would say darkness, but I'm a finance guy, and he got his Ph.D. in history.

It's true; isn't it?

MR. SANATI: Yes.

MR. GENSLER: But what happens in a run -- go back to George Bailey's situation -- but what happens in Iran is everybody's running for safety. Everybody's -- when I said it's everybody trying to get out the door, think of a theater and somebody screams, "Fire." I mean, just think of the visual. That's how financial markets work in a crisis or a panic.

We had a little of that on May 6th, they were studying now, the SEC and we are studying.

So everybody is trying to run to safety. And derivatives in that moment, that are not centrally cleared, create more uncertainty.

Will my counterparty be able to perform, and I have a 30-year open contract, and a 30- or 20-year open contract on oil or interest rates or whatever, but will they be able to perform. And if am worried that they won't be able to perform, I'm not going to enter into any more trades with them, but I'm also going to try to find any way that my lawyers can trigger the current trades. I think that's what you're referring to.

Whereas the central clearinghouse model, it can't do it for 100 percent of the market; but if Jamie Dimon's right and says it's 75 to 80 percent of the market, that's a heck of a step forward to put three-quarters of the market into the central clearinghouse functions.

I think, in September of 2008, the biggest story on derivatives was clearly AIG. I've been accused by some opponents to reform, that we're using AIG to try to ride to get all of this stuff.

Those people would say it's all about a couple of things. They would say it's only about consolidated supervision. If we only had reform to bring consolidated supervision, AIG should have had somebody looking over the whole thing. And secondly, it's about credit default swaps. Credit default swaps mean lots of regulation.

I would say that would be the core the opponents would say.

When President Obama's transition was meeting and it was then just Tim Geithner, Mary Schapiro and myself, not like big buildings with lots of staff, none of the three of us thought it was just that. I mean, it was all -- we have to cover the whole product suite, interest-rate derivatives, currency derivatives, oil and commodity derivatives, equity, credit default swaps. So the only suite of products.

And then it wasn't just about regulating the dealers, the swap dealers being the consolidated supervision; but we had to have a mandate for clearing. And then the toughest political question was whether we had a mandate for trading.

But we basically, by January of '09, sitting in that -- I remember that office, that transition office -- said, "Let's" -- I mean, it took a lot more months to get this all written up -- but, "Let's do the whole product suite," you know, and, let's not just focus on the dealers, but the three key components of reform or comprehensive dealer regime, mandatory clearing for that 75 or 80 percent that conclude cleared; and then what was most politically charged was a mandate to bring as much of that 75 percent -- maybe not all of the 75 percent, but as much of it to some central trading.

And if there's not enough liquidity for the trading, at least have real-time post-transition reporting.

So that's the story. Next time you interview, I might have a different story.

MR. SEEFER: That would be very interesting.

Again, I know your time is short and I appreciate the time. We'll talk to Tim about --

MR. GENSLER: And I apologize because I just did a monologue. That wasn't much of an interview.

MR. SEEFER: No, but you know what? Now, we can digest this and come back and pepper you with some questions.

MR. GENSLER: Are you the derivatives team, or are you doing everything? I mean, what are --

MR. SEEFER: Both. Yes.

The way we are doing things is looking at everything the entire year but focusing on certain areas within that as we gear up for hearings on a subject. And the next hearing, among other things, is going to be on the role of derivatives.

MR. GENSLER: Can you –- let me know, because it’s quite possible you’re going to give me a formal invitation -- what’s the date?

MR. SEEFER: The date, as of now -- and it has changed once already -- would be either June 30th or July 1st.

MR. GENSLER: Okay.

MR. SEEFER: No decisions have been made.

Or else we would have brought a formal invitation.

MR. GENSLER: Right. Yes, yes, yes.

MR. SEEFER: As if you are right, that we are certainly considering you.

The folks are up in the air on what exactly do we want to do at the hearing. And now that it got pushed to the end of the month, people will figure they have more time to think about it, I suspect.

But Chairman Gensler has always been on a list of potential witnesses for a hearing.

MR. GENSLER: I’d be honored to do it. If you don’t invite me to, I’m honored to.

I think -- I hope by then the President will have signed a financial reform bill that we've got through House and Senate conference. But nothing's ever certain in Washington. But I think it's still very relevant. What's the history of -- how did derivatives play a role in this particular crisis? I think they magnified and concentrated risk and leveraged; and I, secondly, think that they had a very, I would say, corrosive role in the mortgage underwriting process. The whole -- the whole mortgage underwriting and securitization chain, those would be the two things that I would have to prove out -- I mean, Cyrus would have to prove out in my written testimony.

And then, you know, if you wanted me to talk anything about the history -- I mean, I think the history, which I captured in that Columbia speech is just -- I mean, certainly I think about it. Knowing what we know now, should those of us that were in those roles back then done more? Yes, yes.

But we didn't know then what we know now.

And these assumptions, these five assumptions -- you know, you have this sort of broad, international debate that would peak up in '87 or '88, '92, '98, you know. And each time that the debates -- and they probably had their other debates in Europe, too -- I think those were some of the factors why people said, “No, maybe not. It’s really an institutional market. We’re kind of regulating these folks, anyway,” and other kind of unique and bilateral. You know, those points.

MR. NORMAN: If I can digest quickly what you just said, it had a corrosive role in the mortgage origination process?

MR. GENSLER: Mortgage underwriting and syndication.

MS. NORMAN: By making it seem safer by taking -- or wrapping them?

MR. GENSLER: I think -- not on the streets of, you know, Seattle or Baltimore or anywhere, where somebody was getting -- I mean, I think that there were bad practices by subprime brokers. I don’t think it had a direct role there. I think further down the chain, I should have said, if I did, mortgage underwriting and mortgage securitization.

But you have to take -- I mean, I don’t know if you’ll do it this way, but a mortgage all the way from, you know, the homeowner, all the way to the other end, that’s packaged in a sliced-up synthetic CDO. I think they did have a corrosive effect further down the chain in terms of the underwriting practices and the syndications. Because in the syndications and underwriting practices, they basically, when you leave parties, investors with a sense that they have less risk, they'll pay more for something. It's part of what leads to a bubble when risk is mispriced.

I mean, fundamentally, though there were many causes of the crisis, one of the big central themes of the crisis is risk, is always in society, but it sometimes gets mispriced. And I think -- I think risk got seriously mispriced in this, the risk of individual homeowners defaulting; the risk overall of an asset bubble declining. People didn't call it a bubble, just the risk that housing prices would decline was underpriced.

And the other risk that I think was significantly underpriced was the earlier risk I had talked about, liquidity risk, which doesn't directly relate to derivatives.

But I think that -- I think liquidity risk was fundamentally underpriced. I think the risk that overall asset values would decline was underpriced and under-appreciated.

I think the risk of homeowner default was ultimately -- and the rating agencies played a role, bad underwriting practices played a role; but credit default swaps played a role in that.

Does that help?

MS. NORMAN: Yes, I was just trying to figure out the --

MR. KARPOFF: We really have to stop.

MS. NORMAN: Sure.

MR. GENSLER: Tim. Iron-fisted Mr. Karpoff.

Come on, everybody's got to have a Mr. Karpoff.

MR. SEEFER: You're right.

(End of interview with Gary Gensler)

--o0o--

4813-3605-2230, v. 1