

MEMORANDUM FOR THE RECORD

Type of Event: Interview with Gary Gensler, CFTC Chairman

Date of Event: 5/14/2010

Time: 1:30p.m.

Location: CFTC Office 1155 21st Street, NW, Washington, DC 20581

Participants – FCIC: Chris Seefer, Dona Norman, Greg Feldberg, Randall Dodd, Mike Easterly and Jon Armstrong

Participants – Non-FCIC: Gary Gensler Dan Berkovitz- General Counsel, Cyrus Amir Mokier, Senior Counsel to the Chairman

Memorandum prepared 5/18/2010

Date of Memorandum: 5/18/2010

MFR Prepared by: Jon Armstrong

Summary of the Interview: This interview primarily focused on the history of derivatives and regulation in addition to the underlying causes of the financial crisis.

I. Factors that Led to The Financial Crisis

A. Significant Economic Imbalances.

1. We went into this period of time with low and declining savings rates. And these are global imbalances.
2. There were also very high savings rates in Asia, particularly in China and in the Middle East.
3. The Evidence of the global imbalances.
 - a. very low savings rates, significant trade imbalances and moving from budget surpluses to budget deficits.

B. The low interest rates at the Federal Reserve and the very easy monetary policies of

the early decade.

C. The Underwriting Practices and the Whole Pipeline

1. The Problem with Subprime Lending Prompted us to put out a report on subprime lending. We had a series of recommendations.

D. Another Factor was the Mortgage Finance Companies

1. Most of the firms that came into trouble were not federally regulated.
2. We have a very patchwork-quilt sort of environment for regulation.

E. The Rating Agencies also played a Crucial Role.

1. They are the Gatekeepers. Their function very much broke down.
2. Not even suggesting it's a lack of regulation.
 - a. Quote "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."
 - b. 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.

F. No Consolidated Supervision of Complex Financial Institutions

1. This was something known in the 90's.
2. 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.

3. AIG fell into this category

G. Over Reliance on Short Term Lending

1. Some people would say that financial intermediation is all about bringing people together who have money and who need money. But it's bringing together people that have a risk and want to lay off that risk, and somebody who is willing to bear the risk.
2. But financial intermediation is also about maturity mismatches. This is at the core of financial institutions.
3. Regulators also haven't had enough cushions for liquidity runs.

II. The Underlying Assumptions that halted the regulation of derivatives in Europe, Asia and the United States.

- A. The parties to these contracts were all sort of sophisticated parties large enough to fend for themselves.

1. This has proven to ignore that there are larger, broader more and more systemic implications.
2. We're proposing that the SEC and CFTC have explicit role writing authority to protect business conduct, protect business conduct from fraud, manipulation, and other abuses in the marketplace.

- B. The institutions that were operating as dealers, what we are now calling "swap dealers," were basically regulated, anyway.

1. The affiliates of the investment banks, the AIG affiliate, they weren't really effectively regulated.
2. 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.

3. There are not explicit rules about how to do netting and back office documentation etc.

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

1. There are just too many externalities to leave it to chance.

D. The Hedging Practices are bilateral, basically highly tailored, and are not susceptible to centralized market structures.

1. This is something that was probably true in the 80's, but has become less true in the nineties and as computerization too off.

III. The Role Derivatives Played in the Financial Crisis

A. It was a very real role. The over the counter derivatives are an important hedging tool 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.

B. Over-the-counter derivatives can add to the leverage in the system.

1. 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.

C. Derivatives and CDSs Played a Major role in the Home-mortgage securitization chain.

1. These products by 2004 and 2005 being used in the securitization chain that had some very adverse effects.

Concluding Quote by Gary Gensler about the financial Crisis, “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. “