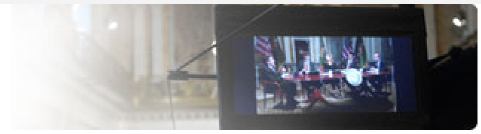

Treasury Secretary Timothy F. Geithner Written Testimony before the Senate Committee on Agriculture, Nutrition and Forestry Hearing on OTC Derivatives Reform and Addressing Systemic Risk

12/2/2009

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Chairman Lincoln, Ranking Member Chambliss, members of the Senate Agriculture Committee, thank you for the opportunity to testify today about a critical component of our financial reform package – a comprehensive framework for regulating over-the-counter (OTC) derivatives.

Let me begin by discussing the larger context within which this component fits – a broad and thorough reform of our financial system designed to protect Americans from the consequences of a preventable economic collapse.

In the years leading up to the crisis, our financial regulatory regime permitted an excessive build-up of risk, both inside and outside the traditional banking system. The shock absorbers critical to preserving stability – capital, margin, and liquidity cushions in particular – were inadequate inside the banking sector and woefully inadequate in critical places outside the banking sector. As a result, our overall system was too weak to withstand the failure of large, interconnected financial firms.

To make matters worse, the government did not have the tools to handle the failure of major firms in ways that kept it from destabilizing the financial system and imperiling the economy.

There was also a fundamental failure of consumer protection. Millions of Americans were sold products they did not understand and could not afford. In some cases, this was the result of irresponsible choices by households. But in many of these cases, people were misled by unclear disclosures, overly complicated contracts or loan originators whose incentive was to close deals regardless of borrowers' ability to pay.

The Administration has proposed comprehensive reform to address the causes of the recent crisis and reduce the risk of future crises.

We have proposed to establish a new Consumer Financial Protection Agency with the power to establish and enforce protections for consumers across a wide array of financial products.

We have proposed to extend the scope of prudential regulation beyond the traditional banking sector to cover all financial firms whose failure could pose a threat to financial stability.

We have proposed to put in place more conservative constraints on risk taking: tougher capital and liquidity requirements for financial institutions, and stronger cushions in the critical market infrastructure. And we have called for standards on our largest and most interconnected financial firms to be substantially higher than those on other firms. These higher standards would substantially reduce the probability that large, interconnected firms fail. They would require these firms to internalize the costs that they impose on the system. And they would give these firms incentives to shrink and reduce their complexity, leverage, and interconnections.

We have proposed that the government have authority – as we do today for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly way that imposes pain on shareholders, creditors, and managers, but limits collateral damage to the financial system and spares taxpayers.

And we have proposed to work with other countries to establish strong international standards, so that the reforms we put in place here are matched and informed by similarly effective reforms abroad.

Over the past few months we have worked closely with Chairman Lincoln, Chairman Dodd, Chairman Frank, Chairman Peterson, members of their Committees, and other Members of Congress to craft strong financial reform legislation.

I have been particularly pleased by the convergence on good policy that we have seen in the derivatives bills produced by the Senate Banking Committee, the House Agriculture Committee, and the House Financial Services Committee, and I know this Committee is hard at work on its own 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.

The rapid growth and innovation in the markets for derivatives, especially OTC derivatives, has been one of the most significant developments in our financial system during recent decades.

Because of their enormous scale and the critical role they play in transferring risk around our financial system, establishing a comprehensive framework of oversight for the OTC derivative markets is crucial to laying the foundation for a safer, more stable financial system.

A derivative is a financial instrument whose value is based on the value of an underlying "reference" asset. The reference asset could be a Treasury bond, a stock, an interest rate, a corporate loan, a mortgage-backed security, or a non-financial commodity such as oil or copper or corn. Although some derivatives are traded today on regulated exchanges, the vast majority are traded off exchanges, or over the counter.

The OTC derivative markets grew explosively in the decade leading up to the financial crisis, with the notional amount or face value of the outstanding transactions rising more than six-fold to almost $700 trillion at the market peak in 2008. Over this same period, the gross market value of OTC derivatives rose to more than $20 trillion.

Although derivatives bring substantial benefits to our economy by enabling companies to manage risks, they also pose very substantial challenges.

Under our existing regulatory system, some financial firms were allowed to sell large amounts of protection against certain risks without adequate capital to back up those commitments. The most conspicuous and most damaging examples of this phenomenon were the monoline insurance companies and AIG. These firms sold massive amounts of credit protection, including on mortgage-backed securities and other more complex real-estate related securities, without the capacity to meet their obligations in an economic downturn. And banks were able to get substantial regulatory capital relief by buying credit protection on mortgage-backed and other asset-backed securities from these firms, which were thinly capitalized, special purpose insurers subject to little or no initial margin requirements. Regulatory requirements and market discipline were both weak and failed to constrain in any meaningful way the exposures of banks to these thinly capitalized firms.

The apparent ease with which derivatives permitted firms to transfer risk during a period of global expansion and ample liquidity led financial institutions and investors to take on imprudent amounts of risk.

The complexity of the instruments that emerged overwhelmed the checks and balances of internal risk management and government supervision. And these weaknesses were magnified by systematic failures in judgment by credit rating agencies. The result was a substantial increase in leverage across the financial system.

Because of a lack of transparency in the OTC derivatives and related markets, 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. So, when the crisis began, regulators, financial firms, and investors had an insufficient basis for judging the degree to which trouble at one firm spelled trouble for another. This lack of information magnified contagion as the crisis intensified, causing a damaging wave of margin increases, deleveraging, and credit market breakdowns.

The lack of transparency in the OTC derivative markets, combined with insufficient regulatory power to police these markets, left our financial system more vulnerable to fraud and manipulation.

These problems were not the sole or even the principal cause of the crisis, but they contributed to the crisis in important ways. They need to be addressed as part of comprehensive financial reform. And they cannot be adequately addressed within the present statutory framework.

In designing its proposed reforms for the OTC derivative markets, the Administration has attempted to achieve four broad objectives:

- Preventing activities in the OTC derivative markets from posing risk to the stability of the financial system;
- Promoting efficiency and transparency of the OTC derivative markets;
- Preventing market manipulation, fraud, and other abuses; and
- Protecting consumers and investors by ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Our detailed legislative proposal, which is now working its way through Congress, provides a comprehensive approach to derivatives regulation that meets the core objectives set forth above. The plan provides for strong regulation and transparency for all OTC derivative transactions, regardless of the reference asset, and regardless of whether the derivative is customized or standardized. In addition, our plan provides for strong prudential and business conduct supervision and regulation of all OTC derivative dealers and other major participants in the OTC derivative markets.

To meet the Administration's core objectives, comprehensive derivatives reform should include the following substantive elements:

First, all derivative contracts that are liquid and standardized should be cleared through well-regulated central counterparties.

Central clearing involves the substitution of a regulated clearinghouse between the original counterparties to a transaction. After central clearing, the original counterparties no longer have credit exposure to each other – instead they only have credit exposure to the clearinghouse. Central clearing of 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.

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. This two-channel approach to determining which derivative types must be centrally cleared 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.

We also should require that regulators carefully police any attempts by market participants to use spurious customization to avoid central clearing.

Second, 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.

Third, all OTC derivative dealers and other major OTC derivative market participants should be subject to tough prudential supervision and regulation, including conservative capital requirements, conservative margin requirements, and strong business conduct standards. Conservative capital and margin requirements for OTC derivatives will help ensure that dealers and other major market participants have the resources necessary to make good on the promises they have made to their derivative counterparties.

Fourth, the OTC derivative markets should be made fully transparent. Clearable derivatives should be required to be traded on regulated exchanges or regulated electronic execution facilities. Such a requirement should result in improved price discovery for liquid derivative markets and for many of the reference assets on which derivatives are based. The requirement also should lead to greater price competition among dealers and improved prices for end users of derivatives.

In addition, relevant regulators should have timely and complete access on a confidential basis to the transactions and open positions of individual market participants. And the public should have access to aggregated data on open positions and trading volumes.

To bring about this high level of transparency, the CFTC and SEC should have authority to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. Counterparties to OTC derivatives that are not centrally cleared should be obligated to report each transaction to a regulated trade repository on a timely basis.

These reforms will bring OTC derivative trading into the open so that regulators and market participants have a clear view into the market and a greater ability to assess risks in the market. Increased transparency will improve market discipline and regulatory discipline, and will make the OTC derivative markets less volatile.

Fifth, the CFTC and SEC should be provided with clear authority for civil enforcement and regulation of fraud, market manipulation, and other abuses in the OTC derivative markets.

Sixth, the standards that govern who can participate in the OTC derivative markets should be tightened. We must zealously guard against the use of inappropriate marketing practices to sell derivatives to unsophisticated individuals, businesses, and municipalities.

Finally, we must continue to work with our international counterparts to help ensure that our strict and comprehensive regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries.

These reforms will help prevent the OTC derivative markets from threatening the stability of the overall financial system. They will do so by requiring central clearing of clearable derivatives and by requiring that all OTC derivative dealers and other significant OTC market participants be strictly supervised by the federal government, maintain substantial capital buffers to back up their obligations, and comply with prudent initial margin requirements.

These reforms will help make the derivative markets more efficient and transparent and thus help ensure that the government is not caught – as it was in this crisis – with insufficient information about market activity, risk concentrations, and connections between firms. They will do so by requiring that all clearable derivatives be executed on regulated exchanges or regulated electronic execution facilities and by requiring that detailed information about all derivatives be readily available to regulators.

These reforms will help prevent market manipulation, fraud, and other abuses. They will do so by providing full information to regulators about activity in the OTC derivative markets, by providing the CFTC and SEC with full authority to police the markets and impose position limits, and by taking steps to prevent OTC derivatives from being marketed inappropriately to unsophisticated parties.

Both chambers of Congress are moving quickly now to consider, deliberate, and pass legislation to reform our financial system, and the Administration stands ready to help advance the process. We welcome the commitment of the Congressional leadership and of the key Committees, including the Senate Agriculture Committee, to move forward with legislation in the coming weeks. This is an enormously complex project. It is important that we get it right. And it is critical that we finish the job.

The recent crisis caused enormous damage to trust and confidence in the U.S. financial system, to the American economy, and to the ability of individual Americans to thrive. We share responsibility for fixing the system, and we can only do that with comprehensive reform – reform that includes strong oversight of the derivatives markets.

We look forward to working with you to achieve that objective.

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