

Testimony of Tyler E. Gellasch
Before the House Committee on Agriculture,
Subcommittee on Commodity Exchanges, Energy, and Credit
Regarding
Review the Impact of Capital and Margin Requirements on End-Users

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Chairman Conaway, Ranking Member Peterson, Chairman Scott, Ranking Member Scott, and other Members of the Committee, thank you for inviting me here today.

Effective derivatives regulation is an incredibly important topic for our economy, and one in which I have deep interest. A little more than seven years ago, I left private law practice and joined the Senate staff at a time when our country was facing the worst financial crisis in generations. As counsel to a senior United States Senator who also chaired the Senate Permanent Subcommittee on Investigations, I had the privilege of assisting the Senator with investigating the causes of the crisis and crafting legislation designed to prevent future crises. Later, I had the privilege of helping regulators carefully implement that legislation as intended.

I now run a small consulting firm, Myrtle Makena, and also serve as Executive Director of the Healthy Markets Association, an investor-focused non-profit coalition focused on equity market structure issues. The testimony I give today represents my own views, and not necessarily those of my association or its members.

The Financial Crisis

This Committee is continuing a conversation that began in earnest as the world was coming to grips with the worldwide financial meltdown. Beginning in the fall of 2008, over the course of just a few months, US regulators began pouring several trillion dollars into the financial markets to help prop up and save some of the largest financial firms.¹ Many people remember the \$700 billion Troubled Asset Relief Program (TARP), which pumped tens of billions of dollars into AIG, Bank of

¹ The US government and regulators used more than a dozen new and previously existing programs (and more than 21,000 transactions) to provide trillions of dollars in assistance to U.S. and foreign financial institutions to promote liquidity and prevent a financial collapse. That's on top of the FDIC and Treasury Department extending guarantees to trillions of dollars in assets for a range of institutions and markets. *See, e.g.*, Press Release, Department of the Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds (Sept. 29, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1161.aspx>; see also, *Temporary Liquidity Guarantee Program: Fourth Quarter 2010*, FDIC.

America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, Wells Fargo, and others.²

But why did AIG³ and the banks need rescuing in the first place? What went wrong? How could these enormous firms, with hundreds of billions of dollars on their balance sheets—and billions more off their balance sheets—suddenly teeter on the brink of collapse? The answer is why we're here: margin and capital. Or more importantly, it was the lack of them.

It is worth recalling how that happened. Beginning in the 1990s, the swaps market grew rapidly as a remarkably efficient way to transfer risk between parties.⁴ And while many people appreciate that a mortgage crisis precipitated the financial crisis, what most people don't know (or at least didn't until *The Big Short*) was how bad mortgages on Main Street actually helped cause a financial crisis on Wall Street. That happened through big bets, particularly in swaps, and lack of margin and capital to back up those bets.⁵

² See, <https://www.treasury.gov/initiatives/financial-stability/reports/Pages/TARP-Housing-Transaction-Reports.aspx>.

³ Other non-bank financial firms also suffered enormous losses. Some were bailed out (directly or indirectly), while others were not. For example, Lehman Brothers Holdings Inc., with more than 209 registered subsidiaries spanning 21 countries, was not bailed out, leaving courts around the world wrestling with how to apply more than 80 different jurisdictions' insolvency laws to untangle more than 900,000 outstanding derivatives contracts. Michael J. Fleming and Asani Sarkar, *The Failure Resolution of Lehman Brothers*, Federal Reserve Bank of New York Economic Policy Review (Dec. 2014), available at <https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf>.

⁴ These efforts were aided by increased financial engineering, standardization of terms and basic contracts (such as the development of the ISDA Master Agreement, Credit Support Annex, and CDS Model), and deregulation. See also Futures Trading Practices Act of 1992 and the Commodity Futures Modernization Act of 2000.

⁵ For example, suppose I borrow \$10 from Lending Corp and promise to pay it back \$11 next year. Lending Corp might be worried that I won't pay it back. So Lending Corp could buy insurance, called a credit default swap, from Swap Corp. This swap may cost Lending Corp 25 cents. Swap Corp collects 25 cents today, and if I don't pay back Lending Corp in 1 year, Swap Corp pays Lending Corp \$11. Either way, Lending Corp should make a 7.5% return on its loan to me (\$11-\$0.25). That seems reasonable enough.

Now suppose ten other firms all buy the same "insurance", even if they don't have any interest in my repaying Lending Corp? They're just speculating on me repaying Lending Corp. Each time, Swap Corp will dutifully collect their 25 cents, giving it \$2.25.

If I repay Lending Corp, Lending Corp gets its \$11, and Swap Corp will keep its \$2.25 in payments. But what if I don't repay Lending Corp? Swap Corp will suddenly owe \$110. Unless Swap Corp has significant backup capital, Swap Corp may not have enough money to pay up. After all, it only took in \$2.25. And what about Lending Corp and the other ten firms, who may now be relying on that \$110 dollars to pay their bills? There's the potential for chaos.

Swap out the name Swap Corp from my example and call it AIG. In the run up to the crisis, AIG sold this type of default insurance on billions of dollars of mortgage-related

The Senate Permanent Subcommittee on Investigations conducted a years-long bipartisan investigation into figuring out how bad mortgages turned into a global financial crisis, and wrote up its findings in a comprehensive staff report.⁶ So too did the Financial Crisis Inquiry Commission.⁷ Other Congressional committees, prosecutors and regulators also researched the issues. They all found that financial firms had created financial instruments linked to mortgages that increased the level of risk and leverage to financial firms—in particular, because of inadequate margin and capital.

Because these financial instruments were traded with so little margin and the firms had so little capital, once any doubt was raised about the ability of the other side to pay up, it immediately imperiled the liquidity—and quickly, the solvency—of the entire system.

In many ways, what the government did in 2008 and early 2009 was funnel money to all of the major financial firms so they could make good on their bets. For AIG, this meant that taxpayers effectively gave AIG enough money to post margin and pay its bets,⁸ while also buying out some of the bets directly.⁹ Thus, AIG's

products. It dutifully collected the quarters, but when it came time to pay up the dollars, it didn't have the money.

This highly stylized example is also overly conservative. In many instances, the party selling protection (e.g., AIG), charged significantly less than the 2.5% suggested above. This premium was often sold as basis points, often settling well-below 1%. The rapid rise in perceived risk of default may often lead to a rapid rise in CDS premium rates. Still, the overall rates were below what one might suggest. For example, during the Greek debt crisis days of 2010, 5 year CDS on Greek sovereign debt jumped to a little over 4%. The impacts of these changes, however, are often dramatic on the borrower, as the increased CDS prices are often priced into the sales of new debt.

⁶ *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, Majority and Minority Staff Report, (Apr. 13, 2011) (“Senate Financial Crisis Report”).

⁷ *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, Financial Crisis Inquiry Commission, (2011), available at <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

⁸ Press Release, *AIG Discloses Counterparties to CDS, GIA, and Securities Lending Transactions*, American International Group, Inc., March 15, 2009, (“AIG Press Release”), Attachment A. For example, after receiving billions in TARP funds in September 2008, AIG used a whopping \$52 billion to support trading done by its London-based Financial Products group. Of that, it funneled \$22.4 billion to its counterparties as collateral for CDS trades and another \$12.1 billion paying back municipalities. That doesn't count the \$43.7 billion used to pay back firms (largely banks) with securities lending deals, nor the \$29.6 billion a Federal Reserve-sponsored financing unit, Maiden Lane III, used to pay AIG and its counterparties for its CDS contracts. AIG Press Release. For just the CDS collateral bets, AIG paid out as CDS collateral \$4.1 billion to Societe Generale, \$2.6 billion to Deutsche Bank, \$2.5 billion to Goldman Sachs, and \$1.8 billion to Merrill Lynch. AIG Press Release, Attachment A.

collapse may be thought of as a poster child for what happens when there are inadequate counterparty credit protections—again, margin and capital.¹⁰

Regulatory Response to Financial Crisis—Increasing Margin and Capital for Derivatives Trading

Almost immediately, governments around the world recognized that swaps and those who trade a significant amount of them needed to be better regulated. In September 2009, the G-20 Summit in Pittsburgh reflected a commitment by world leaders to strengthen the international financial regulatory system by, amongst other things:

- Building high quality capital and mitigating pro-cyclicality;
- Improving over-the-counter derivatives markets, including by requiring “non-centrally cleared contracts ... to higher capital requirements”; and
- Addressing cross-border resolutions and systemically important financial institutions by year-end 2010.¹¹

By that time, we in the United States were already working on parallel legislation to make many of those enhancements. The key components to reform, now embodied by the Dodd-Frank Act, were generally:

- Imposing a comprehensive reporting regime to ensure that regulators (and firms) would have a better understanding of the number, scope, and nature of derivatives trades;
- Reducing counterparty credit risks, by increasing clearing, margin and capital requirements;
- Reducing systemic risks by enhancing capital requirements; and

⁹ See, e.g., AIG Press Release, Attachment B (reflecting payments of \$6.9 billion to Societe Generale, \$5.6 billion to Goldman Sachs, \$3.1 billion to Merrill Lynch, and \$2.8 billion to Deutsche Bank).

¹⁰ As Senator Chris Dodd stated in early 2010, “But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don’t hold enough capital to back up their risky bets and regulators don’t have information about where the risks lie. AIG was a classic example, of course, where that happened.” 156 Cong. Rec. S5828-01 (July 14, 2010) (statement of Hon. Chris Dodd, U.S. Senator). Interestingly, AIG was warned before the collapse that its bets were bad. The model for Ryan Gosling’s character from *The Big Short*, Greg Lippmann, told Senate investigators that he spent hundreds of hours trying to convince AIG to stop buying RMBS and CDOs, and stop selling single name credit default swaps (CDS) on those securities. Senate Financial Crisis Report, at 343.

¹¹ G20 Leaders Statement: The Pittsburgh Summit (Sept. 2009).

- Enhancing market integrity by improving business conduct, increasing transparency, and expanding authorities to police market abuses.

Each of these areas is complex, and the details have taken time to iron out. For example, one area I know of interest to many of you is how the supplemental leverage ratio may impact liquidity for some end users. In the same vein, Title III of the Terrorism Risk Insurance Program Reauthorization Act of 2015 exempted certain swaps from margin requirements.¹² Making sure the true “end users” are not unduly negatively impacted by the new rules is an important goal. That said, I generally think the current rules do a very good job of that.

Now, after six years of discussions, proposals, and court battles, many of the rules are just now being finalized.¹³ In one of the most important rulemakings completed since the financial crisis, the U.S. prudential regulators and the CFTC have recently finalized margin rules.¹⁴ While some aspects of the rules have been practically mandated for years through safety and soundness supervision, the provisions technically are coming on-line over the next year or so.

Role of Margin and Capital Requirements

Ensuring swaps transactions have sufficient margin and capital is at the center of the reform effort – precisely because those who lived through it saw how dangerous the lack thereof was to the system.¹⁵ But why is that? Why do margin and capital play such an important role in the experts’ approach to addressing the regulatory failings of the 2008 financial crisis? In no small part, it is because they address the systemic breakdowns of 2008. Both serve the same ultimate goal of

¹² This mandate was implemented as an interim final rule, which became effective on April 1, 2016. See *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, Commodity Futures Trading Commission, 81 Fed. Reg. 636 (Jan. 6, 2016).

¹³ Foreign regulators are engaged in a similarly slow process, as many of their rules are also not yet in effect, and may be yet again delayed beyond 2017. Silla Brush and John Detrixhe, *EU Weighs Softer Derivatives Rules as MiFID Delay Bogs Down*, Bloomberg, Apr. 16, 2016.

¹⁴ *Margin and Capital Requirements for Covered Swap Entities*, Office of the Comptroller of the Currency, Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration, and the Federal Housing Finance Agency, 80 Fed. Reg. 74840 (Nov. 30, 2015); see also *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, Commodity Futures Trading Commission, 81 Fed. Reg. 636 (Jan. 6, 2016). In general, the prudential regulators (e.g., the Board of Governors of the Federal Reserve System) are setting the capital and margin rules for the swap dealers and major swap participants under their purview, and the markets regulators (e.g., the CFTC) are setting the same rules for the swap dealers and major swap participants under their purview. These rules are not the same, nor would necessarily I expect them to be, given the different regulators and regulated entities.

¹⁵ See G20 Leaders Statement: The Pittsburgh Summit (Sept. 2009).

ensuring that parties are able to meet their financial obligations, but they each go about achieving their objectives in different ways.

For the benefit of those watching at home, margin is just collateral. Just like the collateral of the home reduces the bank's risk of the borrower's default on a mortgage, so too does margin directly reduce the risk that the trading counterparty won't pay – often called counterparty credit risk.

Most commonly, this margin is broken into two components—initial and variation. The initial margin is what the participants pay at the beginning of the relationship. The variation margin changes as the values of the relevant trading positions change, such as due to the regular fluctuations of our many markets. As a party looks increasingly likely to pay up, the margin could and should increase to reflect that, because if it did not, the other party would be more exposed financially to the risk of its counterparty not paying—again, its counterparty credit risk.¹⁶ However, margin often comes with a direct cost to the party required to post it. Margin is typically in the form of cash, Treasuries, or other extremely liquid, stable value securities. This provides a stable and known value, but it also provides effectively no return for the party posting it. It isn't able to help them right now, nor is it likely to grow much in value. This often leads many firms to resist having to post margin.

That said, because of its efficacy at reducing counterparty credit risk, margin has been a hallmark of capital and derivatives markets for nearly a century. Why? Because, at its most basic form, margin enables market liquidity in a highly efficient way. By posting margin, multiple parties can trade with each other without massive amounts of due diligence, a costly and time consuming endeavor. Put another way, without margin, parties are trading with each other only to the extent that they fully trust the other party will pay them back, even if they go bust.¹⁷

¹⁶ Here, for simplicity, I treat both initial and variation margin collectively as margin. However, it should be noted that the ratio of obligations between the two may be significant. And there is no clear-cut “right” mix. Policymakers may elect to require lower initial margin in return for requiring greater sensitivity and higher potential variation margin. This comes with increased variability in margin costs for participants. Conversely, increasing initial margin may be accompanied by decreased variation margin requirements. This may stabilize margin level for participants, but may also result in higher overall margin levels and costs.

¹⁷ Notably, derivatives enjoy highly preferential treatment under the bankruptcy code, making them far more likely to be paid in the event of bankruptcy than other types of liabilities, such as pensions (or even secured creditors). This treatment may both incentivize the use of derivatives, but it also may lead to sub-optimal social or financial outcomes, something that US Senator Elizabeth Warren has highlighted when proposing to repeal this treatment. *See, e.g.*, Interview of Elizabeth Warren, U.S. Senator, C-SPAN, Nov. 13, 2013, available at <http://www.c-span.org/video/?c4473182/senator-warren-derivatives-seniority-bankruptcy>. For a review of some of the economic impacts of this special treatment, see Patrick Bolton and Martin Oehmke, *Should Derivatives Be Privileged in*

In the over-the-counter (OTC) markets, the amount of collateral required and the quality of collateral has evolved significantly over the past several years. Before the crisis, financial firms, of course, would regularly pledge collateral, but the amount was typically relatively low. Many non-financial firms previously were able to trade without pledging any collateral (the increased risk was just priced into the contract). To the extent collateral was pledged, it could be working assets.

Not requiring margin is effectively an embedded loan. There is nothing inherently wrong with embedding a loan in a trading transaction, but we should be clear about what it is in practice: the party not requiring margin is taking the risk that it will not get paid back. It is reasonable to expect that a financial firm in most circumstances will be able to manage the risks of extending that type of credit to an ordinarily sized, non-financial end user. That is essentially their business, after all. Moreover, those trades make up a relatively modest part of the overall trading going on in these markets.

Since the crisis, and in response to regulatory efforts around the world, an increasing percentage of derivatives trades are centrally cleared. As centralized clearing has taken root, the total collateral used to support non-cleared derivatives has fallen.¹⁸ Non-financial firms still generally aren't required by regulators to post margin or maintain specific capital.

Overall, the amount of collateral and the quality of the collateral required across the system has generally increased, in part driven by renewed oversight from banking supervisors and in part driven by market demands on counterparties, including through central clearinghouses. Thus, between the increase in centralized clearing and the increase in amount and quality of collateral in non-cleared trades, the risk that a party will be unable to pay up on its trade is today much lower than it was just a few years ago.

Capital, by contrast, indirectly reduces counterparty credit risk by ensuring that a firm generally has enough assets to pay all of its reasonably foreseeable obligations. This is particularly important for a derivatives dealer, such as a bank or firm like AIG, since this protects from concentration risks that trade-specific margin requirements may not adequately address. Here, adequate capital requirements help supplement margin rules. If margin is the first line of defense, capital is the last.

Bankruptcy?, Journal of Finance (2015), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2023227. Preferential treatment notwithstanding, some might also say that the 2008 financial crisis proved that the ultimate guarantors of those private and implicit promises are the American taxpayer.

¹⁸ International Swaps and Derivatives Association, Inc., *ISDA Margin Survey 2015*, at 3 (Aug. 2015) (reflecting a decrease from \$5.34 trillion in 2013 to \$5.01 trillion in 2014).

Capital also has one big advantage over margin. Unlike margin, which typically produces little or no financial return for the posting party, capital is not pledged away, nor is it necessarily in super-stable, super-low yielding assets.¹⁹ It can, and often will, provide a modest return to the holder.

Disparate Impacts of Margin and Capital Requirements on Different Types of Firms

Before specifically addressing some of the concerns about market impacts of margin and capital rules, I want to acknowledge the distinct differences between firms engaged in swaps trading, and how margin and capital requirements might impact them differently.

First, there are the largest banks and bank-affiliated firms. For these firms, financial assets are relatively easy to come by. They are, after all, financial institutions with relatively low borrowing costs and often-excellent access to a wide array of assets. They also have complex oversight and risk management systems (including sophisticated risk modeling systems²⁰) that allow them to monitor and manage their cash-flow requirements. In addition, they have historically conditioned to having capital and margin requirements. For these firms, incremental increases on margin or capital requirements are not likely to have profound impacts on *how* they do business. Changing margin and capital rules can, however, impact their overall profitability to the extent that it may restrict their leverage and increase costs for accessing high-quality assets.

Next, outside of the handful of the mega-banks, there are the other financial firms. These firms are likely regulated by the Commodity Futures Trading Commission and the Securities and Exchange Commission. They have traditionally operated under much less proscriptive capital regulatory regimes than banks, a fact that was highlighted by the collapses of Lehman Brothers, MF Global, and Bear Stearns. In addition, depending upon their business, these firms may not have significant amounts of liquid assets readily available for posting margin. Of course, some of these firms are deeply involved in swaps trading, and may have material

¹⁹ In response to the financial crisis, however, regulators around the world, particularly banking and prudential regulators, have taken steps to improve the quality and quantity of capital held by financial firms.

²⁰ Bank regulatory capital requirements, and compliance with them, have in recent years become increasingly complex, and model-driven. However, the efficacy of these models to provide meaningful evaluations of risk is nevertheless limited in many respects. For example, even basic metrics, such as Value-at-Risk, may be significantly altered by revisions to how the calculations are made, or the values of the inputs. For a detailed case study of potential failures of risk modeling, please see *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*, Homeland Security and Government Affairs, Permanent Subcommittee on Investigations, Majority and Minority Staff Report, at 165-213, (Mar. 15, 2013).

swaps exposures, while most do not. Some are very familiar with posting liquid assets as margin while others are not. Further, while some of these firms may have sophisticated trade and risk management systems, including complex modeling capabilities, most do not.²¹

Finally, we have the non-financial firms. They include farmers, agricultural firms, manufacturers, and thousands of other firms that we might think of as the true “end users”. If properly defined, these firms comprise a very small percentage of overall swaps trading. And for them, margin or capital rules would seem unnecessary, inappropriate, and unduly burdensome. In addition, many do not typically have liquid financial assets available to use for posting margin, nor do they typically operate under a concept of regulatory capital. Imposing these limitations may have profoundly negative impacts on their operations. That’s why Congress and regulators have already generally exempted these firms from the margin and capital requirements.

Regulations, Liquidity, and Costs

Many have worried that banking and derivative regulations may reduce the number of counterparties, decrease liquidity, and increase costs for market participants.²² To date, I have seen no evidence of margin and capital requirements disrupting markets or increasing costs for “end users.”

Of course, concerns about the potential impacts of new rules on liquidity and costs are equally present in a broad swath of financial markets, including Treasuries, corporate bonds, and equities.²³ The results of the limited studies so far have been encouraging.

²¹ One of the key issues facing a firm under U.S. rules is determining whether it has “material swap exposures.” However, I understand that some non-bank financial firms may have difficulty in making such a determination without significant revisions to their oversight systems or outside assistance.

²² It is important to note that “liquidity” has no precise definition. For my purposes, I define it as the “ability to rapidly execute sizable securities transactions at a low cost and with a limited price impact.” *Global Financial Stability Report*, International Monetary Fund, at 53 (Oct. 2015) (“IMF Global Financial Stability Report”), available at <https://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/text.pdf>.

²³ For example, in the Omnibus appropriations bill this past year, Congress directed the Securities and Exchange Commission’s Division of Economic and Risk Analysis to provide Congress with a report on the impact of the Volcker Rule and other regulations, such as Basel III, on “(1) access to capital for consumers, investors, and businesses, and (2) market liquidity, to include U.S. Treasury markets and corporate debt.” As one of the drafters of both the Volcker Rule legislation and the multi-agency rule to implement it, I will be interested in this study’s findings.

Despite dire prognostications, these reforms seem to not be negatively impacting liquidity. According to the International Monetary Fund, liquidity measures in the bond markets in the US, Europe, and even emerging market economies are generally better than 2007 levels.²⁴ For example, when experts at the Federal Reserve Bank of New York looked late last year at the corporate bond markets, they found that liquidity is better than it has been at any time since the financial crisis.²⁵ Bid-ask spreads are tighter than they have been in years and trading price impacts are way down.²⁶ All while dealer inventories have fallen.²⁷ So the sky hasn't exactly fallen—unless you're a bank with declining inventories and trading revenues. Even then, decreased bank revenues may be more of the results of stable asset prices, a near zero interest rate environment, and other non-regulatory factors.²⁸

Coming back to the swaps world, despite dire warnings of the demise of all liquidity and skyrocketing costs, to date, there doesn't seem to be much of any impact on the real “end users”—the farmers and manufacturers. Indeed, a recent study by the Bank of England found that enhanced swaps requirements from Dodd-Frank, including central clearing – which itself includes margin and certain other requirements on members – as well as trades through swap execution facilities, resulted in enhanced market liquidity and a significant reduction in execution costs.²⁹

Additional facts bear out the story that effective derivatives regulation is beginning to work without imposing new negative ramifications on the markets.

First, the OTC derivatives market is still enormous. According to the Bank of International Settlements, the total notional amount of OTC derivatives outstanding

²⁴ IMF Global Financial Stability Report, at 58.

²⁵ Tobias Adrian, *et al*, *Has Corporate Bond Liquidity Declined?*, Liberty Street Blog, Federal Reserve Bank of New York, Oct. 5, 2015, available at <http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html#.Vx2DtHopko0> (looking at corporate bond markets).

²⁶ *Id.*

²⁷ *Id.*

²⁸ IMF Global Financial Stability Report, at 67 (“Risk appetite and funding liquidity seem to be the main drivers [of bond market liquidity], but indirectly the results point to an important role for monetary policy.”).

²⁹ Evangelos Benos *et al*, *Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act*, Staff Working Paper No. 580, (January 2016), available at <http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp580.pdf> (finding significant cost savings in the interest rate swaps markets as a result of these changes).

at the end of June 2015 was \$553 trillion,³⁰ about 79% of which involved interest rate derivatives.³¹ The gross market value of these positions was \$15.5 trillion.³²

Second, true “end users” are almost entirely exempted from new derivatives rules, including the margin and capital requirements.

Third, to date, I have seen no credible study demonstrating increased costs or burdens on “end users” resulting from these regulations. The writing has been on the wall—even if not the final rules—for more than six years. Margin and capital have been increasing for years now, and yet end users still seem to be able to trade what they need.³³

Fourth, the mix of firms providing swaps trading services has been changing for a long time before the advent of new regulations. The largest banks unquestionably have traditionally enjoyed a huge advantage in the trading markets, with extremely low funding costs, large balance sheets, and sophisticated trading and risk management operations. Those advantages have helped drive consolidation here, just as it has in other financial services areas—and it is not unique to derivatives trading.

How margin and capital rules will impact that consolidation, however, remains unclear. I understand this Subcommittee has heard from some non-bank financial firms that new rules—particularly for capital requirements—may unnecessarily restrict their ability to engage in swaps trading.³⁴ On the other hand, some large banks themselves and outside consultants have started modeling out

³⁰ Bank of International Settlements, OTC derivatives statistics at end-June 2015, at 1 (Nov. 2015), available at http://www.bis.org/publ/otc_hy1511.pdf.

³¹ *Id.*, at 2.

³² *Id.*, at 1.

³³ I note that much of the single name CDS market remains largely stalled. That said, to the extent that the products served a valuable purpose, I expect there to be continued use of other financial products to hedge credit risks, as well as continued efforts to restart the CDS products. The Intercontinental Exchange’s buy-side-centric CDS trading platform announced last August is a timely example. Mike Kentz, *ICE plans single-name CDS platform*, Reuters, Aug. 31, 2015, available at <http://www.reuters.com/article/markets-derivatives-cds-idUSL1N1161A520150831>. In fact, in a headline that echoes from the run-up to the financial crisis, it was recently reported that due to “tightness” in the availability of some asset-backed securities, some investors may be increasingly turning to credit derivatives. See, Joy Wiltermuth, *Investors Turn to CMBS derivatives for liquidity*, Reuters, Apr. 22, 2016, available at <http://www.reuters.com/article/usa-corpbonabs-abs-idUSL5N17N4TL> (reflecting that total notional values in derivative CMBX contracts increased from \$141 billion to \$181 billion from 2015 to 2016).

³⁴ See, e.g., CFTC Reauthorization, Before the House Committee on Agriculture, Subcommittee on Commodity Exchanges, Energy and Credit, 114th Cong. (2015) (statement of Mark Maurer, Chief Executive Officer, INTL FCStone Markets, LLC), available at http://agriculture.house.gov/uploadedfiles/maurer_testimony.pdf.

whether and how they might be better off spinning out some or all of their derivatives trading operations to avoid the new rules.

To me, it is at least worth exploring whether isolating derivatives trading operations in separately capitalized firms that are outside of the taxpayer-protected banks could be beneficial for the markets and to removing an implicit taxpayer subsidy for the largest participants. Nevertheless, I suspect the key funding and capital advantages of the largest banks will ultimately prevail as they have since well before the crisis.

In sum, the new rules don't seem to be changing much other than simply imposing moderately enhanced protections for counterparties at the cost of moderately higher margin and capital for the major players in these markets.

International Regulatory Coordination and Cross Border Regulation

As the financial crisis unfolded, regulators around the world immediately recognized that swaps regulation needed to be effectively coordinated across national boundaries.

AIG was a New York-based firm whose London-based Financial Products unit brought down its worldwide operations. But this was not the first or the last US-based firm to suffer from financial troubles resulting from trading done abroad. In fact, offshore derivatives trading has played key roles in collapses ranging from Enron to Lehman Brothers. And in 2012, it was the London-based trading group of JPMorgan Chase using "excess deposits" to trade illiquid credit derivatives that cost it approximately \$6.2 billion. In each case, the US firm was on the hook for losses.

Regulators have been acutely aware of these instances, and the risks of regulatory gaps and arbitrage. The Pittsburgh Summit laid out the blueprint for the G-20. In the United States, Congress empowered the regulators by saying that they could regulate swaps trading that has "a direct and significant connection with activities in, or effect on, commerce in the United States."³⁵ This broad jurisdictional authorization was deemed critical, because, as a CFTC Chief Economist later put it, "risks taken by foreign affiliates, subsidiaries, and branches of U.S. parent companies are usually borne by the U.S. parent."³⁶

³⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 722, (2010).

³⁶ Declaration of Sayee Srinivasan, Chief Economist, Commodity Futures Trading Commission, Mar. 14, 2014 (cited in *Securities Industry and Financial Markets Association, et al, v. CFTC*, Civ. N. 13-1916, 5 (Sept. 16, 2013), available at <https://secure.fia.org/downloads/SIFMAvCFTCOpinion.pdf>).

The creation of artificial jurisdictional divides between different international regulators poses one of the greatest risks to effective oversight of these markets. The largest financial firms have dozens, if not hundreds, of affiliated entities around the world, all designed to support the overall business. If a firm can avoid capital requirements or margin rules by simply shifting its trading, technology, or basic reporting structure to another jurisdiction, it may likely do it. But the risks may still remain where they were before. Policymakers and regulators in the United States should be cautious about exempting foreign branches or affiliates of U.S.-based firms from any of our rules, but margin and capital in particular.³⁷

To date, the US regulators have been extremely active in collaborative international efforts to impose largely similar derivatives oversight regimes around the world.

US policymakers and regulators should continue the work, and the recent mutual recognition determination is a great step forward. However, I would strongly recommend against further delaying implementation of critical reforms on the grounds of imposing rules only where there may be complete international consensus. Foreign regulators are no more immune to lobbying efforts from the largest financial firms than those in the US. And we must be cognizant that multinational firms may seek to play domestic and foreign regulators off each other.

Lastly, while different regimes may be similar, they are not identical. While some regulators may focus heavily on margin, others may focus more on capital. Some regimes place greater emphasis on reporting requirements than others. This

³⁷ U.S. regulators have proposed to link application of many aspects of the Dodd-Frank-related reforms to the presence or absence of a “guarantee.” *See, e.g., Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, Commodity Futures Trading Commission*, 80 Fed. Reg. 41376 (July 14, 2014). Legislators and experts have long expressed concerns that this could easily lead to the “de-guaranteeing” of swaps, while not changing any of the fundamental relationships between affiliated entities. *See, e.g.,* Letter from Jeff Merkley, U.S. Senator, *et al*, to Hon. Gary Gensler, Chairman, CFTC, *et al*, July 3, 2013, available at <https://www.merkley.senate.gov/news/press-releases/senators-urge-cftc-sec-to-close-major-swaps-loophole-and-prevent-bailouts-from-implied-us-guarantees-on-swaps>; *see also* Letter from Americans for Financial Reform to Hon. Tim Massad, Chairman, Commodity Futures Trading Commission, and Mary Jo White, Chair, Securities and Exchange Commission, Nov. 25, 2014, available at <http://ourfinancialsecurity.org/wp-content/uploads/2014/11/De-Guaranteeing-Letter1.pdf>. The CFTC sought to address some of these risks by finalizing guidance on its definition of “U.S. person” in July 2013. *Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations*, Commodity Futures Trading Commission, 78 Fed. Reg. 45292 (July 26, 2013). These risks could also be more effectively addressed through the imposition of appropriate margin requirements for trades done by foreign affiliates.

is natural, as it is within our fifty states to see differences in any number of regulatory areas.

Path Forward

US regulators and policymakers should not forget the lessons of the past decade, where inadequate regulation of derivatives blew whale-sized holes through the balance sheets of some of the largest financial firms in the world, forcing regulators and US taxpayers to step into the markets with trillions of dollars just to save the world's economies.

It seems only fitting that, in the aftermath, regulators have worked together to develop comprehensive regulatory regimes to:

- Improve reporting of derivatives so firms and regulators can better understand their exposures and risks;
- Reduce counterparty credit risks by pressing for more centralized clearing and imposing basic capital and leverage restrictions; and
- Reducing systemic risks by imposing heightened capital and leverage requirements on financial firms.

These are important goals. I urge you to keep the pressure on the regulators to get the job done. We are in mile 25 of this marathon. Now is the time to finish implementing these essential rules to protect US businesses, municipalities, and families. I have confidence that, with your support, our regulators will be able to implement smart and effective derivatives rules that will continue to promote—not hinder—our economy.

Thank you for the opportunity to speak with you today, and I look forward to any questions.