Chairman Lincoln, Ranking Member Chambliss, and Members of the Committee, thank you for inviting me to testify before you today. The American people clearly sense that there is something deeply flawed in the current structure of our financial markets and the political process that has spawned them. One does not need to be a Ph.D. in finance or economics to grasp that the ship is way off course and in need of correction. Too Big to Fail is a demoralizing eyesore that even the CEO's of the largest firms agree must cease to exist.\(^1\) Losses of wealth, lost employment and economic activity and bailouts totaling trillions of dollars around the world are strong evidence of the failed structures of financial markets in their current form. The financial sector's calamity has spilled over and done great harm to the lives of many Americans and people throughout the world.

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When they are properly designed, financial markets play a fundamental role in the resource allocation for our society. Well functioning markets are an important means to achieve our societal goals. Financial markets, when functioning correctly, serve to aggregate savings and allocate them to productive uses. Financial markets also serve to allocate risk to entities that bear it most comfortably. The system we had in place in recent years, and the one that is still in place as we meet today, has revealed profound flaws.

The Senate Agricultural Committee has, in its history, seen the benefits the derivatives markets can create when they are transparent, have safeguards against manipulation, and restrict excesses of speculation. These markets can provide a powerful resource allocation tool, provide a mechanism to distribute risk and at the same time need not prey upon the resources of civil society.

At the same time, the recent history of unregulated credit default swaps following the passage Commodities Futures Modernization Act that culminated in the failure and bailout of AIG illuminates the danger of potential legislation that does not adhere to basic principles of sound market structure.

Efforts to repair these market structures in light of the diagnosis of the crisis that began in 2007 should, in my view address the elements that caused the
crisis. I would suggest that study of the crisis reveals that at the core we have 4 problems:

1) Excessive leverage
2) Opacity and complexity rather than transparency and simplicity
3) That ability to buy insurance without an insurable risk
4) A misalignment of incentives where the private incentive to take risk exceeds the social desire to bear risk.

Certain types of derivative instruments, their market structures and the associated regulatory structures, have contributed to all of these problems. It is time, in light of experience, for a thorough redesign of these market systems to enhance the real potential of derivative instruments and the repair the obvious flaws in structure have caused so much harm.

I must admit that I am very surprised by the intense focus on “End Users” of derivative instruments. That focus does appear to me to have substantially misdirected energy away from the essential task of financial reform before the

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I draw particular attention to the comments of Edward Kane on the current subsidies imbedded in OTC derivatives.

“‘Even if dealers keep much of the benefit for themselves, everyone is getting derivatives more cheaply at the expense of the taxpayer,’” says Edward Kane, a professor of finance at Boston College.”
United States Congress that centers on the role of the large financial institutions in creating that crisis. This diversion to end user obsessions is a dangerous exercise for at least two reasons.

First and foremost, efforts to legislate what types of institutions are exempt from the restrictions of healthy market practice runs the risk of creating loopholes large enough to fly a jet aircraft through. End user exemptions that are drawn too broadly serve to allow anyone and everyone to claim them, especially the large and too big to fail financial institutions that stand next to the public treasury. That would directly undermine the need to bring these markets out of the dark. It would enable the largest market participants to remain in the shadows where they earn extraordinary profits but put society and the public treasury in peril.

In addition, end user exemptions may inadvertently serve to spawn large speculative organizations or divisions of organizations that are given substantial advantage over financial institutions by legislation. The spawning of Enron-like

My thoughts are very similar to the conclusions of this editorial which states,

“The trickiest issue concerns exemptions for end-users, such as manufacturers. Allowing companies to hedge their risks is the whole point of the instrument. But if the rules favour them over financial companies, trading will tend to migrate towards them, and away from banks. AIG, once the world’s biggest insurer, thought it was making “easy money” by using its strong credit rating to sell protection against credit defaults; in fact, it was digging its own grave.

These reforms may raise the price of using derivatives, but that would not necessarily be a bad thing. When fire and theft premiums rise, those who really need insurance still pay up. “
entities is the risk implicit in creating legislative that confers special advantage for certain types of market participants.

Secondly, the exemption of certain classes of financial products such as foreign exchange forwards and swaps, or any products that are traded on foreign platforms will surely serve to drive more activity offshore, perhaps to locations where the underpinning market structures are themselves unsound. This is akin to the process where manufacturing employment moves to where proper labor rights and environmental restrictions are not present. The movement of resources offshore leads to private profit at the expense of greater pollution and social harm.

Foreign exemptions will also likely divert creative energy into the creation of complex “foreign exchange” based products to qualify for that exemption and thereby avoid the scrutiny and structures that healthy market structure and regulation require. That would also undermine the need to bring these practices into the light.

There has been a great deal of testimony, here today, and before other Congressional committees, that goes to great length to justify end user exemptions. This body of testimony tries to illuminate the consequences for end users of requiring them to trade upon exchanges or submit their transactions to
clearinghouses. While I do agree that some increase in cost will be borne by these end user institutions if the current market structures are replaced by more robust and healthy market structures, I believe the magnitudes of the costs they report they would incur are somewhat exaggerated and that they pale in comparison to the trillions of dollars of lost output and employment that this crisis has caused, even for their own firms. I agree with them that end users were not the primary cause of this crisis and that they are not deserving of any particularly punishment. Yet punishment is different than adjustment to the removal of an unhealthy subsidy. I cannot agree with many of their conclusions and descriptions of the likely consequence of the changes to our financial market structures that are necessary to prevent a crisis of this magnitude from recurring in the not too distant future.

First of all, as economists are fond of saying, there is no free lunch. Efforts to hedge market exposures by commercial users are primarily a transfer of risk, rather than a diminution of the underlying risk. An oil hedger is not reducing the volatility of oil prices, but merely transferring to another party, for a price, who will bear that oil price volatility. When market structures are weak and unsound they serve under-price that insurance and the implicit subsidy encourages the overuse of insurance. In the case of the OTC derivatives market that is largely run by the handful of TBTF banks, the insurance offered to end users is under priced because the risk is in part borne by the public/taxpayers
who underpin the safety net that backstops those banks. Removing that back
room subsidy and the excessive use it inspires, something called moral hazard,
would lead to an increase in the cost of providing risk transfer insurance and
would have the impact that many end users describe in their testimony.
Removing a subsidy would lead to a diminished profits, and less use of insurance
and some more costs for the consumers of those services. Where I differ from
many of the end users claims is that I believe that this would be a good thing for
the nation and the economy as a whole. Removing subsidies to the buyers of
insurance does not make the world a more dangerous place. It merely
redistributes who bears that risk away from those who had heretofore provided
the subsidy.

The American private sector, be they end users of financial products or
financial institutions, does not need to clamor for subsidies from the taxpayer in
order to thrive. That type of rent seeking behavior is demoralizing for society
and unproductive. It weakens the economy in the long run. It preys upon the
general interest and at the same time government willingness to honor those
efforts to extract subsidies from the public fisc actually weaken the companies
who would do much better in the long term if they were to be refused state
welfare and forced to focus on new product development and innovations in the
marketplace that would create a more profitable productive future.
Reforming the financial structure of the U.S marketplace is essential to restore confidence in the U.S. capital markets and to stabilize the U.S. dollar as the reserve currency of the world. Transparent market structures, proper capitalization, regulation and restoration of market discipline to our largest financial institutions are the essential ingredients needed to restore integrity and confidence to our marketplace. They are a public good that nourishes us all. The transition from subsidy based commerce to a proper realignment of incentives for the use of financial instruments is a painful but healthy transition. If done properly it will also greatly diminish the possibility that future financial bailouts will reemerge and crowd out the use of our public finances for much needed infrastructure, education spending and healthcare that make our society stronger.

I will submit the balance of my remarks for the record.

The Importance of OTC Derivatives Reform

OTC derivatives reforms are, in my view, the centerpiece of the financial reforms that are necessary to address the flaws of our financial system that were revealed by the crisis that began in 2007-8. Derivative instruments are pervasive and their regulation is intimately intertwined with the health of the financial system. The experience of AIG and their exposure to unregulated credit
default swaps (CDS) is the most glaring example of the reckless nature of an unregulated derivatives market. CDS buyers in the so-called shadow banking system felt that their purchased protection was a substitute for bank shareholder capital. Yet the writers of the CDS protection, in the case of AIG, did not appear to, and were not required to, set aside adequate capital. As a result, the taxpayer’s capital was extracted to support the counterparties of AIG such as Goldman Sachs and a number of foreign banks who did not pay into any kind of guarantee pool for insurance. This web of connections was considered too dangerous to let fail and it was an example of the hazards of unregulated OTC derivative market breakdown. The AIG debacle is an important structural episode to learn from, but it is not the only one. Derivatives regulation is not a subject to be treated in isolation. OTC derivative reform impacts all of our financial system’s vital interconnections. It is the very fabric of our financial system.

I believe that the most important dimension of all of the needed financial reforms is the precise intersection between Too Big to Fail financial institutions and OTC unregulated derivatives. This intersection is the equivalent of the San Andreas Fault of our financial system. We are in a new era where the size of the capital markets, and their derivative instruments are a dominant dimension of the intermediation of credit. Derivatives transparency is essential to the safety and soundness of our financial system as a whole and it is essential to the protection
of the public treasury. Without OTC derivatives reform enhanced resolution powers for dealing with insolvent institutions could well be rendered impotent and future crises in the credit allocation system will likely be longer and deeper than is necessary.

End User Arguments and The Social Impact

In recent letters and testimony some end users have emphasized the impact on jobs and the competitiveness of their firms if they were to lose access to customized derivatives and be forced to rely solely upon standardized contracts.

The impacts of changes in market architecture are important for the Committee to understand when it considers new legislation. At the same time it is important to understand the context of these claims and the overall impact on employment of any changes you enact. We have a financial architecture in place governing derivatives that has failed profoundly. The bailout costs, lost output around the world, and breathtaking rise in unemployment are the result of that financial failure. When an end user talks about how changing practices in the derivatives market will end up costing jobs at his firm one has to place this in that context. If a dysfunctional derivatives market has led to over use of derivatives throughout the system and has made them too cheap to use because
provision for the integrity of the system was not built into the costs, then it is imperative to improve that system architecture and force the end use to incur the costs they rightfully represent that they will experience. The resulting system, fortified and more transparent and well regulated, would reduce the likelihood, and magnitude, of a recurrence of a financial calamity. Not only would society be better off with lower unemployment, but the end user in question would likely experience less disruption to demand for his/her product and not be forced to lay off as many employees in the event of a disruption. Reform would increase jobs and stability of employment in his/her own sector in the larger scheme of things. We have, in recent years, had a financial system where the private incentive to take risks exceeds the social value of those risky actions. We have subsidized financial speculation indirectly and underpriced insurance by not setting up proper market structures, particularly in the aftermath of the Commodities Futures Modernization Act. When a subsidy is diminished, those who benefit from it are forced to adjust, profits are curtailed, and employment diminished at the margin. Those effects are important to understand, but they do not constitute a reason to refrain from repairing a broken system. Society and the end users are each likely to be better off when the system’s integrity is repaired. The kind of disruptions to commerce we have recently experienced are enormous, dreadful and unnecessary.
The challenge for the Committee will be to create legislation that preserves as much scope for deriving value from derivative instruments for end users without making the definition of end user so broad that it allows large scale financial institutions to effectively continue their unregulated OTC practices and at the same time assures that end users do not themselves, through loopholes, contribute to a weakening of the integrity of the financial system. Derivatives coupled with Too Big to Fail firms have shown that they are very dangerous. I applaud your efforts to undertake this formidable challenge.

DERIVATIVES ARE A LARGE PRESENCE IN CAPITAL MARKETS

OTC derivatives markets are vitally important because of their size, and because of where positions are concentrated in relation to other vital functions of our economy/society. Derivative contracts have become an enormous proportion of the total notional credit exposure in U.S. and world financial markets. According to the International Swaps and Derivatives Association (ISDA) survey, the outstanding notional amount of derivatives is over 454 trillion dollars at mid year 2009. The Bank for International Settlements puts the number at nearly $800 trillion worldwide. Using ISDA data, that is over 30 times U.S. GDP.
According to the flow of funds data from the Federal Reserve, total credit market debt outstanding is just under $53 trillion dollars. Derivatives are not a minor dimension of U.S. or international capital markets. They occupy a dominant position.

The location of derivatives exposures is also important. According to the U.S. Office of the Comptroller of the Currency report for June 30th, 2009, U.S bank holding companies with $13 trillion in assets hold a notional $291 trillion in total derivatives. Most importantly, the institutions that were at the core of the crisis and controversial bailouts in the fall of 2008 are at the same time the dominant institutions in the OTC derivatives market. In fact, according to the Office of the Comptroller of the Currency, the Top 5 institutions in terms of derivatives exposure, Citigroup, J.P. Morgan/Chase, Bank of America, Morgan Stanley and Goldman Sachs hold over 95 percent of derivatives exposure of the top 25 Bank Holding Companies, of which 90 percent is OTC. This is why I call this the financial equivalent of the San Andreas Fault. Our Too Big to Fail Institutions, the same ones that have relied on the support of the public treasury in the crisis, are the dominant market participants in the OTC derivatives market. As a result, U.S. taxpayers have a very strong and direct interest in how the derivatives markets are structured and regulated.

**DERIVATIVES REFORM IS A KEY ELEMENT OF TOO BIG TO FAIL POLICY**
Derivative securities are a sizeable proportion of the risk on the balance sheets of our largest bank holding companies. That is a reasonably recent development occurring over the last 25 years. In the era of depression reforms, bank lending and securities holdings were the dominant asset on bank balance sheets. The interface between government and our largest financial institutions, starting with the founding of Central Banks, and continuing through the creation of deposit insurance, was predicated on a traditional banking model. As deregulation and consolidation proceeded side by side over time, the chain of credit intermediation became much more complex. Capital markets grew in importance relative to bank intermediation of credit. The explosive growth of derivatives markets transformed credit allocation and rendered many of the traditional policies designed to protect the essential functions of credit markets obsolete. The vision that informed those policies remained largely based on the structure of the traditional banking model. The OTC derivatives market, which is so deeply interwoven into the operations of our largest scale financial institutions, can no longer be ignored. I believe, that the so-called Too Big to Fail policy is intimately intertwined with derivatives regulation policy. Along with international harmonization of resolution laws, derivatives regulation is the essence of the capacity to resolve failing institutions on a timely and least-cost basis to protect our taxpayers. It would not be too strong to say that the architecture of derivatives regulation and market structure is the heart of Too Big to Fail policy.
Absent a drastic simplification of derivative exposures and a transparent and comprehensive improvement in the monitoring of those positions when imbedded in large firms, complex derivatives render these behemoth institutions Too Difficult to Resolve (TDTR). I say that because, the policies of resolving troubled financial institutions, so-called enhanced resolution powers, cannot be invoked unless government authorities have the capacity to assess and understand the entanglements of derivatives exposures throughout the financial sector and the economy at large. Resolution powers themselves can be quite useful and should be passed into law as a part of the financial reform you are considering. The ability to undertake “prompt corrective action” vis a vis bank holding companies and financial services holding companies, as the FDIC can now do vis a vis failing banks, would diminish the probabilities of a cascading bankruptcy or other disruptive panic. Yet opaque, complex entangled derivatives exposures would serve to deter the authorities from invoking those powers and taking over a failing institution for fear of setting off a system wide calamity of magnitudes that policy officials can dread but not understand or estimate. Complex entanglements through derivatives exposures discourage government officials who are the risk managers on behalf of the citizens of our nation from invoking and using those powers. The spider web of complex opaque derivatives renders enhanced resolution powers impotent. It is in this respect that complex and opaque derivatives exposures at large financial
institutions contributed mightily to a policy of induced forbearance, as we witnessed in the first quarter of 2009. That experience, as we have seen, was very demoralizing to our citizens who have put their faith in philosophies that emphasize the use of markets as a mechanism for achieving social goals. The inhibitions that authorities experience in applying market discipline to large financial institutions and their managements tend to undermine belief in the use of markets.

What makes induced forbearance of TDTR institutions even more troubling is that their potential creditors would understand that they will not have their debts restructured when government officials are deterred by complex derivative exposures from taking a TDTR institution into receivership and restructuring the entity. This would create the perverse impact of reducing the risk premium on the unsecured debt of these institutions, lowering their funding costs, and giving them incentive to take more risk. It would also create a competitive advantage for TDTR firms that encourages an increase in their market share relative to those firms who had to pay more for funding because their creditors would fear that their bonds could be restructured in the event of solvency problems. TDTR financial institutions are enabled to get larger and larger by wrapping themselves in a spider web of complex derivatives and thereby inducing authorities to make ever-larger scale gambles on forbearance. Forbearance is a two-sided coin. Firms can continue to lose money rather than
return to health. This is not a tolerable state of affairs for taxpayers who are held hostage by the fear of resolving complex intertwined institutions.

**OPAQUE DERIVATIVES MARKETS BREED FEAR WHEN MARKETS ARE SHOCKED**

The damage done by complex and entangled derivative exposures embedded in financial institutions is not limited to its impact on resolution policies and bailouts. Perhaps even more damaging is their impact at times when the financial system has been adversely shocked, such as was the case when the real estate market bubble burst around the turn of 2006/2007. At such times, when concern about counterparty default risk are heightened, the presence of complex and opaque positions, the value of which are very difficult, if not impossible to ascertain, may engender fear and lead to a freezing up of credit markets. When no one can prove that a financial institution is solvent, even if it is, then the credit allocation process seizes up, and both deepens and prolongs the downturn and the deleveraging spiral that ensues.
Complex OTC derivatives are private transactions. When compared to standardized transactions that are traded on exchanges, they are opaque. OTC transactions are subject to prolonged periods of mispricing. When the prices finally adjust in response to adverse news, capital can evaporate. OTC transactions are capable of imbedding leverage that is difficult to detect. A system that is very large in transaction volume that fosters leverage, opacity and suspect valuation is one that contributes to the fragility and fears that produce heightened perceptions of counterparty default risk and lead to deep and prolonged dysfunction of the credit allocation process. I believe that repair of the regulatory structure of housing finance is necessary but not sufficient to fortify our financial system. OTC derivatives regulation must also be addressed and profoundly redesigned to meet this challenge.

DERIVATIVES MARKETS AND PRICING DO NOT NEED TO BE OPAQUE

I have referred repeatedly to the notion of opaqueness and derivative instruments. They are not one and the same. It is possible to have derivative exposures that are quite easy to evaluate and value. What has been problematic is that many unregulated and OTC custom products are difficult to value. They are private by their very nature, yet when traded by large institutions they butt up

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4 See the Appendix I for information on these differences between OTC, clearing and exchange trading and the role of the Commodities Futures Modernization Act in enabling OTC trading and opacity.
against the public guarantees. It is in this respect that the legislation you are considering is absolutely vital to the functioning of the U.S. financial markets.

Opaqueness relates to valuation. OTC derivatives that are complex combinations are often priced by resorting to mathematical computer models. These models do not reflect actual market prices, but rather, they reflect valuations of securities “as if” perfect markets existed to value them.\(^5\) When actual market conditions, which often include asymmetric information about the underlying quality of a given asset, are present, these “mark to model” prices are for the most part meaningless indications of the worth of that underlying asset. This leads to periods of large and discontinuous changes in the value at which assets are carried on balance sheets and to drastic changes in the measures of available capital. Unfortunately, these discontinuities in pricing are rarely confined to just one institution in the system. Many firms are likely to have the same problem at the same time and then the system as a whole begins to experience capital shortage and forced asset sales in a synchronized manner.

The danger to the economic system that contains a large array of complex customized derivatives is that in large quantities they can create very misleading impressions of the value of an instrument, or more powerfully, a portfolio of

\(^5\) “Perfect markets” is a phrase that refers to assumptions in economic theory. Perfect markets are those that meet all of the assumptions that have been explored by mathematical scholars such as Gerard Debreu and Kenneth Arrow. Suffice to say that the conditions of perfection are so strict that they virtually never are experienced in practice.
positions, or most frighteningly the value (solvency) of entire institutions, that do not get subjected the discipline of real pricing. This arouses suspicion that cannot be dispelled and makes the adequacy of capital unknowable. Regulators themselves can receive reports but cannot discern the true state of health of financial institutions under such circumstances. We saw that in the last two years. It is not just about having a systemic regulator. It is also vital to give that regulator meaningful information that corresponds to the real risk contained within the financial system. GIGO or Garbage In Garbage Out the computers scientists often say. One must be able to accurately diagnose and interpret what is in the report for meaningful regulation and supervision of financial institutions to take place and protect our society.

The remedy for this in the realm of derivatives is to price these instruments based upon real values of actual trades on an open exchange. Exchange traded derivative instruments have real prices based upon actual transactions and the exchange imposes real margin (capital set aside) upon participants to insure their ability to honor their contract obligations. In addition, the exchange itself must put capital up to honor the contracts and the members of the exchange have incentive to make sure that contracts are valued at real market prices. The publication of price data that is based upon trading on the exchange augments the transparency of the process by giving market participants guidance regarding the real value of a particular instrument. Thus pricing and margin are frequently
adjusted and reported in light of ever changing market conditions. Absent that, our regulators, and for that matter, many executives at large institutions, will be like sailors at sea in a fog without a chart of the waters they traverse.

The means to overcome this opacity is to direct nearly all of the volume of derivatives trading onto an exchange. Having said that, a very important dimension of this process, from a system integrity point of view, is that legislators and regulators make sure that the exchange members post sufficiently large capital as members of the exchange so that the problems of Too Big to Fail do not merely migrate from the balance sheets of financial institutions to the balance sheet of the exchange. Proper capitalization is easier to estimate when real prices exist, but the political will to insist on proper levels of capital must also be present.⁶

EXCHANGE TRADING IS PREFERRED TO CLEARING

Many market participants advocate central clearing institutions rather than exchanges as the means to improve market structures. It is clear that such mechanisms are a marked improvement over current OTC practices of carrying trades on the books at mark to model prices. Clearinghouses do require margin

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and mark to market. That is an important step. Yet when compared to exchange-based trading, there is less data published to enhance transparency by clearinghouses than by an exchange. Pricing and transaction costs are more transparent in the case of exchange trading.

**THE COSTS AND BENEFITS TO END USERS OF DERIVATIVES REFORM**

The discussion of OTC derivatives and the accompanying letters from many so called “end users” of derivatives suggest that moving the trading of derivatives from OTC custom contracts to exchanges would entail great cost to their business efforts. I have read the positions presented by several of the end users and I see no reason to doubt the qualitative impacts on their business practices that they suggest. Yet I feel that this tells only a partial story for several reasons.

First, it is difficult to measure the quantitative effects of the loss of perfectly fit custom contracts. It is surely not the case that they must lose all risk management or hedging benefits if derivatives contracts were standardized in time and in adherence to a specific underlying instrument. In the professional practice of hedging there are many methods of imperfect hedging that

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7 I use the phrase “so called” to emphasize that a massive derivatives trading operation such as that created by ENRON would have been deemed an end user by many practitioners. In addition some very large commodity firms have very substantial speculative operations as a key element of their business strategy.
approximate the perfect hedge. The difference between the hypothetical perfect risk management tool, and the risk alleviation that which would result from combining standardized instruments is referred to as “basis risk”. For instance if the only interest rate hedge were a contract that expired on December 21st for 10 year bonds but the company in question wanted to create a contract that hedged them until December 14th the hedge would be imperfect. The cost in terms of basis risk would not be the presence or absence of interest rate hedges, but rather, the 7 day time mismatch in the expiration of contracts. There would still be 7 days left on the contract that the hedger would liquidate one week before expiration of the standardized exchange contract. In practice this is likely to be a very small cost. When futures exist for many of the underlying economic variables, interest rates, foreign exchange prices, and commodities, these imperfect hedges can be easily constructed, even for complex transactions. My overall point is not that there will be no costs, but rather that it is not an “all or nothing decision” that end users face if customized OTC derivatives are unavailable. They would not be left with no risk protection if complex customized OTC derivatives were not available. It would just be less perfect fit. As one of my friends quipped recently, corporate treasurers and bankers would metaphorically have to return to wearing off the rack suits rather custom suits if complex derivatives were eliminated!
My concern, as mentioned in the introduction to this testimony, is that the exceptions created in the name of preserving latitude for customization by the end user actually act to provide a giant sized loophole for financial institutions to avoid standardization and maintain their profit margins from maintaining opaque OTC market structures at great potential risk to the overall economy. It appears to me that the task before Congress is one of reforming the derivatives market structures, making them stronger, more standardized, less opaque, and to afford the maximum degree of precision for risk managers. There is no need for unnecessary restrictions but this is a very slippery slope indeed. Imprecise language, regarding foreign transactions and transactions involving “non major market participants”, appears to create very large potential exemptions that could serve to merely codify current market practice. What is of particular concern is the role that the language could in allowing our largest financial institutions to qualify for those exemptions given their proximity to the public purse. No one wants to see another bailout. I believe the harm done to society if such loopholes are allowed to become law far exceeds the benefits to end users of OTC custom derivatives. OTC custom derivatives should be a special case, with large capital provisioning to support their use and to protect systemic integrity. The vast majority of contracts should be standardized and traded on exchanges. Providing for end users should not be allowed to be a Trojan horse for perpetuating a flawed architecture that makes our financial system more fragile and dangerous.
Furthermore, I do not think that increasing end user costs associated with OTC derivatives reform are substantial and they certainly do not constitute a basis for refraining from substantial efforts to change derivatives regulation in a way that makes our derivatives markets more transparent and our financial institutions more manageable and transparent.

THE IMPACT OF OTC DERIVATIVES REFORM ON LARGE SCALE FINANCIAL INSTITUTIONS

At the core of the impact resulting from proper repair and reform of the regulatory system for OTC derivatives are adjustments in market practice that will impact financial institutions, particularly the very large financial institutions who have been at the center of the bailout and TBTF discussions. A natural consequence of improving transparency and information on pricing is that the intermediaries who dominate the market will see lower profit margins and somewhat lower volume of transactions. The negative impact on earnings of the top banks, that have made more than $15 billion in the first half of 2009 from derivative trading, is likely to be significant. Brad Hintz, a financial analyst at Sanford C, Bernstein and Co. estimates that proper derivative reforms could reduce the earnings of large institutions by 15 percent by moving to clearinghouses and even more if transactions were moved to exchanges.  

9 Wall Street Stealth Lobby Defends $35 Billion Derivatives Haul.
This impact on financial institutions as a result of OTC derivatives reform is important for two reasons. First, one can be rightly concerned, to the extent that these large institutions are the same ones that are borderline, or deeply insolvent as a result of past practices and the crisis. In that case, policies that diminish their earnings will prolong the period in which credit markets are impaired and other forms of revenue, such as credit card fees and usury, are presented to consumers of credit.\(^{10}\) I believe that is a risk and cost we must bear in the name of strengthening our financial system against the threat of another shock. Two wrongs do not make a right. Another crisis of this magnitude will strain society’s resources and the fabric of political consent beyond what any of us want to imagine. Second, making markets more efficient at lower costs is desirable from a social point of view. Financial institutions are a means to an end, rather than an end themselves. Legislation to improve the efficiency of the market system improves the productivity of society and, if at the same time these market structures are repaired to be less vulnerable to crisis it is also of great social value. The diminution of the earnings of Wall Streets largest firms would be a sign of progress and productivity and efforts to resist the transition by Wall

By Christine Harper, Matthew Leising and Shannon Harrington
http://www.bloomberg.com/apps/news?pid=20601109&sid=agFM_w6e2i00

Street firms, while understandable, are harmful to society and the economy on the whole.

WALL STREET PROTECTIONISM

In 1970 the automotive industry was at the apex of the world economy. Yet for many years thereafter, as the automotive industry struggled to adjust to the new realities of global commerce, executives from the Big Three spared no effort of time, money or energy to plead with Congress to relax social policy requirements regarding fuel emission standards rather than devoting their energy and resources to R&D directed at improving their products. The result was that together, the auto industry and Congress produced a failure that is all too evident today.

Today Wall Street and the City of London sit at the apex of the economy, not unlike the automotive companies did nearly 40 years ago. It is my hope that our nation will resist “helping” Wall Street adjust in the destructive way they enabled the auto industry to avoid modernization. Wall Street spent many years in public discourse thwarting and resisting the appeals for protection from the declining manufacturing sector. Is it too much to ask them now to practice what they have preached to other sectors of the economy repeatedly? I am confident in the intelligence and vitality of the men and women who work on Wall Street
today. They are very able and do not need “Wall Street Protectionism” to survive and to thrive. Would it not be better to inspire them, particularly in light of this crisis, to adapt to a more vital market system rather than to acquiesce to their demands perpetuate a system that protects their profits at the risk of exposing society to a danger to the integrity of our financial system that has caused so much hardship in the present and recent past?

Resisting the demands of Wall Street firms on OTC derivatives reform is easy to agree to, in principle, and difficult to accomplish in practice. Market structures with integrity are a public good. As University of Chicago Professor Luigi Zingales has written recently, “most lobbying is pro-business, in the sense that it promotes interests of existing business, not pro market, in the sense of fostering truly free and open competition.”

THE CHOICE: REFORM OR ENDORSEMENT OF A MAN MADE FAULTLINE

Wall Street’s leaders cannot control their urge to seek protection despite the fact that it is demeaning to their reputations. Yet the members of this


Committee and your counterparts in the Senate are responsible for resisting their demands for the good of society. I do believe that this is no minor matter. The financial security and strength of our nation is in the balance. Confidence in the U.S. dollar as the world’s foremost reserve currency depends upon the integrity of our financial system. As I stated at the outset, I believe that the intersection between the OTC derivatives market and the large financial institutions is the financial equivalent of the San Andreas fault. Yet there is one difference. The San Andreas fault is a natural occurrence that we must all cope with to mitigate the consequences of an earthquake. It is beyond our power as people to eliminate. The current state of OTC derivatives regulation and its relation to the guarantees of large financial institutions are a man made fault that is the product of past human errors financial legislation and regulation. It has been revealed by catastrophic events to have devastating consequences. It has produced an avoidable earthquake. That earthquake and its consequences need not be repeated. One can only imagine the consequences for the reputation of those public officials who would choose to act to codify into law this fault line and expose our society to a repetition of the financial crisis that has devastated the world in recent months.

To avoid reform would be harmful enough. We know the fault lines of past human error regarding the regulation of OTC derivatives continue to threaten us. But to affirm the status quo with new legislation that codifies these
structural flaws and deems them to be healthy would be far worse. This is not about just leaving a few crumbs on the table for big financial institutions and asking the rest of us to pay a little more. This is about the representative government of our society choosing to affirm a dangerous financial structure that could explosively harm us all again just after we experienced a severe and unnecessary crisis that resulted from these very failures of design. It would be both dangerous and demoralizing for America and the world if our legislators choose to take that path forward in deference to the parochial desires of a few firms in the financial sector or end users who are clamoring to preserve a subsidy their risk mitigation methods.
APPENDIX I: HISTORY OF ACTIONS CREATING LOOPHOLES LEADING TO UNREGULATED DERIVATIVES.

Exchange Trading vs. Clearing Before CFMA

Under the law governing the regulation of derivatives (the Commodity Exchange Act of 1936 ("CEA") as amended) prior to the passage of the Commodity Futures Modernization Act of 2000, all standardized futures contracts were to be traded on a fully regulated exchange and the futures contracts traded thereon and the exchanges themselves had to be preapproved by the CFTC. Failure to trade a standardized futures contract on a regulated exchange was prior to the passage of the CFMA of 2000 a felony UNLESS the instrument traded was exempt from exchange trading pursuant to a fully transparent CFTC rulemaking process with notice to the public and comment allowed. Such an exemption can only be issued by the CFTC after notice and comment if that agency finds that the off exchange trade is in the public interest and cannot be subject to fraud or manipulation.

The exchange trading requirement includes: full transparency of trading prices and volumes; reporting to the CFTC of large trader positions; anti-fraud and anti-manipulation authority; self regulation by the exchange; and the regulation by the CFTC and exchange self regulation of intermediaries, e.g., futures brokerage houses (called "Future Commission Merchants"), brokers, traders, etc. FCM's are subject to full regulation. Brokers and traders are licensed. Brokers and traders cannot act "recklessly" and if authorized to conduct trades on behalf of customers, brokers owe a fiduciary relationship to the customer. FCM's are strictly liable for the actions of their brokers and traders. By requiring clearing, the CEA assured that there would be capital adequacy supporting trades, i.e., the posting of margin at trade initiation, and collecting margin on a twice a day mark to market process.

The CFMA created two major loopholes to the CEA's exchange trading requirement.

CFMA/SWAPS. Section 2 (g) created the swaps exemption. Under the CFMA, a swaps transaction could be traded off exchange if both counterparties were eligible contract participants (e.g., meet minimal net worth requirements) and if the swap was "subject to individual negotiation." The latter "negotiation" requirement has been honored in the breach. The overwhelming number of swaps transactions are done pursuant to standardized, boilerplate, and copyrighted ISDA (International Swaps Derivatives Association) Master Agreements and accompanying documentation.
**CFMA/ Enron Loophole.** At the behest of Enron, any energy or metals futures product was exempt from the exchange trading requirement at the request of the party wishing to trade these products. The only restriction is that the CFTC has to be notified of the trading. Otherwise, the CFTC has no regulatory oversight except that it can lodge fraud and manipulation actions against this kind of trading. However, because the trades do not need to be reported (nor are there record keeping requirements), it is very hard to bring fraud and manipulation actions.

Because of widespread abuses of the Enron loophole, Congress in May 2008, as part of the Farm Bill, gave the CFTC authority on contract-by-contract basis to reregulate Enron Loophole trading if the CFTC can demonstrate that the contract has a "significant price discovery function." The CFTC recently has begun to reregulate some of these contracts, most prominently the Henry Hub natural gas contract traded off exchange by the Intercontinental Exchange under the Enron Loophole. There have been dozens of hearings before Congress since December 2007, concerning what has now become almost conventional wisdom that the unregulated energy futures markets have contributed to excessive speculation which have unmoored the price of crude oil, gasoline, natural gas, etc. from supply demand fundamentals.