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Testimony

"Review of Credit Derivatives"

Oral Testimony of CFTC Acting Chairman Walter Lukken Before the House Committee on Agriculture

October 15, 2008

Good morning Chairman Peterson, Ranking Member Goodlatte, and other distinguished Members of the Committee and thank you for the invitation to be here today to discuss credit default swaps.

The current financial crisis is requiring policymakers to rethink the existing approach to market regulation and oversight. Many observers have singled out the $58 trillion dollar credit default swap (CDS) market as needing greater scrutiny and transparency. These over-the-counter (OTC) swap transactions are largely unregulated and have exacerbated the counterparty and systemic risk in the financial system during this crisis. The most common credit derivative—the credit default swap contract—works by a "protection buyer" agreeing to pay a premium to a "protection seller" for the obligation that the seller will pay the buyer a specified amount in the event of a default of a corporation or index of corporations. It functions similar to insurance and was intended to be used as a hedge by those with exposure to the issued debt of an underlying corporation. As we have read, however, many participants in these markets were "naked" and did not have exposure to the underlying debt obligation of the companies.

With respect to the CFTC, the Commodity Exchange Act (CEA) excludes most OTC financial derivatives, including CDS, from its regulatory and enforcement jurisdiction. But if we are to avoid repeating the mistakes of the past, we must strive to increase the transparency of these transactions and find ways to mitigate the systemic risk created by firms that offer and hold these off-exchange instruments. While wholesale regulatory reform will require careful consideration, centralized clearing is one immediate and proven response that will help mitigate the current crisis.

Clearinghouses have been functioning for many years as a means for mitigating the risks associated with exchange-traded financial products. Whether securities, options, or futures, centralized clearinghouses ensure that every buyer has a guaranteed seller and every seller has a guaranteed buyer, thus minimizing the risk that one counterparty's default will cause a systemic ripple through the markets. The clearinghouse is able to take on this role because it is backed by the collective funds of its clearing members.

This clearing guarantee goes to the root of the problems we are confronting today – the constriction of credit due to fear of default. Indeed, for futures contracts—the standardized on-exchange predecessor of OTC derivatives—clearing has worked extraordinarily well in managing credit risk. For regulated futures exchanges, the clearing and settlement mechanism serves to lessen the likelihood that large losses by a trader will cause a contagion event. At least twice daily, futures clearinghouses collect payments from traders with losing positions and credit traders with profitable positions. This twice-daily "mark-to-market" prevents the buildup of significant losses and effectively wipes clean the credit risk inherent in the system. Importantly, no U.S. futures clearinghouse has ever defaulted on its guarantee.

Just as significant, the clearing process provides transparency to regulators. When transactions are cleared, government and exchange regulators receive daily trader and pricing information, which helps them to police for manipulation and fraud and to uphold the integrity of the market.

Clearing has been proven to work for OTC derivatives. After Enron's demise in 2001, the OTC energy derivatives markets "locked up" because many energy companies lacked the requisite financial standing to back their off-exchange trades. In response, the New York Mercantile Exchange (NYMEX) sought and received approval from the CFTC in 2002 to clear OTC energy products for the first time. Today, a significant number of OTC energy derivatives are cleared through regulated clearinghouses, which has reduced systemic risk and allowed regulators a greater window into this marketplace. Clearing for OTC products now extends beyond energy products to financial products such as forward rate agreements and foreign currency swaps.

Under existing law, any derivatives clearing organization (DCO) that is registered with the CFTC may clear OTC derivatives without further registration or subjecting itself to any additional regulatory requirements. Pursuant to the CEA, the CFTC regulates DCOs and has the statutory mandate to ensure the financial integrity of transactions subject to the CEA and to safeguard against systemic risk. The CFTC relies on the 14 core principles for DCOs set forth by Congress in the CEA as a means of evaluating whether DCOs comply with U.S. law.

In analyzing compliance with these principles, the CFTC looks to the controls and tools utilized by a clearinghouse, including: (1) appropriate membership standards; (2) collection of position reports from large traders; (3) daily mark-to-market of all open positions; (4) collection of an appropriate amount of performance bond margin, which serves to cover any losses; (5) periodic stress-testing of open positions for extraordinary market moves; (6) an ability to liquidate all of a market participant's open positions quickly; and (7) availability of other financial resources for use by the clearinghouse to cover any member default. Any clearinghouse seeking to clear CDS transactions will need to show in its proposal that it can bring such tools to bear.

The CFTC, in conjunction with other financial regulators, will continue to seek ways to provide clearing solutions for OTC derivatives. Last month, in its swaps report to Congress, the CFTC recommended the further use of clearing for OTC derivatives. There are several private sector clearing initiatives currently being considered by Federal regulators, and it is imperative that regulators work cooperatively and expeditiously to conduct their due diligence and allow appropriate programs to begin operations promptly. The CFTC will continue to closely coordinate with the Federal Reserve and SEC to further this important policy objective.

While the implementation of centralized clearing for OTC products is a near-term solution that does not require legislative changes, broader reform of the OTC derivatives markets is also needed and will require decisive Congressional action. As Congress embarks on reform in the coming months, there are several guiding objectives that should be pursued by legislators to improve the oversight of these markets and prevent a similar economic disturbance in the future.

First and foremost, regulatory reform should seek to improve the transparency of these OTC markets, particularly when their size reaches a critical mass where they play a public pricing role and their failure might cause a systemic event. Clearly the CDS market has met these criteria. Enhanced transparency through reporting or other means would enable regulators to properly police these markets for misconduct and the concentration of risk. In pursuing this objective, Congress might look to the model adopted in the Farm Bill for the OTC energy swaps market, which triggers additional oversight and transparency when a product begins to serve a significant price discovery function.

Second, regulatory reform should incentivize and possibly even mandate centralized clearing and settlement for certain OTC derivatives. As mentioned, clearing brings enhanced transparency, standardization, and risk management to these products at a time when it is most needed.

Third, regulatory reform should revisit the amount of risk-based capital held by dealer firms and large participants in these OTC markets to better account for the interdependent counterparty risk that now seems so evident and to prevent these products from being held off-balance sheet in unregulated affiliates. As clearing begins for these products and trading data improves, models for assessing risk will also progress as will the accuracy of the capital charges assigned to these firms.

Fourth, regulatory reform should provide for clear enforcement authority over these products to police against fraud and manipulation. The CFTC is currently excluded by statute from bringing enforcement cases against OTC financial derivatives. Congress should rectify this by providing clear enforcement powers regarding OTC products to the CFTC and other appropriate regulators, such as the SEC.

Lastly, regulatory reform of OTC products should be globally-coordinated and non-exclusionary. As this financial crisis has shown, the world's financial system is highly intertwined, leaving no country's banking system unscathed. We have also learned that one country's actions to stem the crisis cannot be effective without close cooperation among all nations. As this crisis begins to wane and we turn to pursue long-term adjustments to the global regulatory structure, world legislators must work in close concert with each other to ensure the steps taken by one nation to improve oversight are not exploited by others in the global financial community. This also means that domestic regulators should work in tandem and not engage in the unproductive exercise of defending jurisdictional lines at a time when a comprehensive and coordinated response by regulators is most needed. The entire regulatory community must continue to unite in seeking a sensible and comprehensive solution to the global financial crisis, which may require many of us to rethink our regulatory approaches and jurisdictional biases. The CFTC is committed to playing a constructive role in seeking a cooperative regulatory solution that improves the global regulatory structure for financial markets.

Mr. Chairman, I appreciate your leadership on this critical issue, and I look forward to participating fully in Congressional and regulatory efforts to implement policies and practices that best serve the public interest. I look forward to your questions.