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Chairman Frank, Ranking Member Bachus, Chairman Peterson, Ranking Member Lucas, members of the Financial Services and Agriculture Committees, thank you for the opportunity to testify today about a key element of our financial regulatory reform package – a comprehensive regulatory framework for the over-the-counter (OTC) derivatives markets.

Over the past two years, we have faced the most severe financial crisis in generations. Some of our largest financial institutions failed. Many of the securities markets that are critical to the flow of credit in our financial system broke down. Banks came under extraordinary pressure. And these forces magnified the overall downturn in the housing market and the broader economy.

President Obama, working with the Congress, has taken extraordinary steps to stabilize the economy and to repair the damage to the financial system. As we continue to put in place conditions for economic recovery, we need to lay the foundation for a safer, more stable financial system in the future.

This financial crisis has exposed a set of core problems with our financial system. The system permitted an excessive build-up of leverage, both outside the banking system and within the banking system.

The shock absorbers that are critical to preserving the stability of the financial system – capital, margin, and liquidity cushions in particular – were inadequate to withstand the force of the global recession, and they left the system too weak to withstand the failure of major financial institutions.

In addition, millions of Americans were left without adequate protection against financial predation, particularly in the mortgage and consumer finance areas. Many were unable to evaluate the risks associated with borrowing to support the purchase of a home or to sustain a higher level of consumption.

The United States entered this crisis without an adequate set of tools to contain the risk of broader damage to the economy and to manage the failure of large, complex financial institutions.

Many forces contributed to these problems. Household debt rose dramatically as a share of total income, financed by a willing supply of savings from around the world. Risk management practices at financial firms failed to keep abreast of the rising complexity of financial instruments. Compensation rose to exceptionally high levels in the financial sector, with rewards for executives unmoored from an assessment of long-term risk for the firm, thus mis-aligning the incentive structures in the system. Our framework of financial supervision and regulation, designed in a different era for a more simple bank-centered financial system, failed in its most basic responsibility to produce a stable and resilient system for providing credit and protecting consumers and investors.

The Administration proposed in June a comprehensive set of reforms to address the problems in our financial system that were at the core of this crisis and to reduce the risk of future crises.

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

We proposed to put in place more conservative constraints on risk taking and leverage through higher capital requirements for financial institutions and stronger cushions in the core market infrastructure.

We proposed to extend the scope of regulation beyond the traditional banking sector to cover all firms who play a critical role in market functioning and the stability of the financial system.

We proposed to put in place stronger tools for managing the failure of large, complex financial institutions by adapting the resolution process that now exists for banks and thrifts.

We proposed to reduce the substantial opportunities for regulatory arbitrage that our system permitted by consolidating safety and soundness supervision for federal depository institutions, eliminating loopholes in the Bank Holding Company Act, moving toward convergence of the regulatory frameworks that apply to securities and futures markets, and establishing more uniform standards and enforcement of standards for financial products and activities across the system.

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

Any regulatory reform of magnitude requires deciding how to strike the right balance between financial innovation and efficiency, on the one hand, and stability and protection, on the other. We failed to get this balance right in the past. The reforms that we propose seek to shift the balance by creating a more resilient financial system that is less prone to periodic crises and credit and asset price bubbles, and better able to manage the risks that are inherent in innovation in a market-oriented financial system.

We consulted widely with members of Congress, consumer advocates, academic experts, and former regulators in shaping our recommendations. And we look forward to refining these recommendations through the legislative process.

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

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

A derivative is a financial instrument whose value is based on the value of an underlying "reference" asset. The reference asset could be a Treasury bond or a stock, a foreign currency or a commodity such as oil or copper or corn, a corporate loan or a mortgage-backed security. Derivatives are traded on regulated exchanges, and they are traded off exchanges or over the counter.

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

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

Under our existing regulatory system, some types of financial institutions were allowed to sell large amounts of protection against certain risks without adequate capital to back those commitments. The most conspicuous and most damaging examples of this were the monoline insurance companies and AIG. These firms and others sold huge amounts of credit protection on mortgage-backed securities and other more complex real-estate related securities without the capacity to meet their obligations in an economic downturn.

Banks were able to get substantial regulatory capital relief from buying credit protection on mortgage-backed securities and other asset-backed securities from thinly capitalized, special purpose insurers subject to little or no initial margin requirements.

The apparent ease with which derivatives permitted risk to be transferred and managed during a period of global expansion and ample liquidity led financial institutions and investors to take on larger amounts of risk than was prudent.

The complexity of the instruments that emerged overwhelmed the checks and balances of risk management and supervision, weaknesses that were magnified by systematic failures in judgment by credit rating agencies. These failures enabled a substantial increase in leverage, outside and within the banking system.

Because of a lack of transparency in the OTC derivatives and related markets, the government and market participants did not have enough information about the location of risk exposures in the system or the extent of the mutual interconnections among large firms. So, when the crisis began, regulators, financial firms, and investors had an insufficient basis for judging the degree to which trouble at one firm spelled trouble for another. This lack of visibility magnified contagion as the crisis intensified, causing a very damaging wave of deleveraging and margin increases, and contributing to a general breakdown in credit markets.

Market participants and investors used derivatives to evade regulation, or to exploit gaps and differences in regulation, and to minimize the tax consequences of investment strategies.

The lack of transparency in the OTC derivative markets combined with insufficient regulatory policing powers in those markets left our financial system more vulnerable to fraud and potentially to market manipulation.

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

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

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

Our proposals have been carefully designed to provide a comprehensive approach. The plan will provide for strong regulation and transparency for *all* OTC derivatives, regardless of the reference asset, and regardless of whether the derivative is customized or standardized. In addition, our plan will provide for strong supervision and regulation of *all* OTC derivative dealers and *all* other major participants in the OTC derivative markets.

We propose to achieve this with the following broad steps:

First, we propose to require that *all* standardized derivative contracts be cleared through well-regulated central counterparties and executed either on regulated exchanges or regulated electronic trade execution systems.

Central clearing involves the substitution of a regulated clearinghouse between the original counterparties to a transaction. After central clearing, the original counterparties no longer have credit exposure to each other – instead they have credit exposure to the clearinghouse only. Central clearing of standardized OTC derivatives will reduce risks to those on both sides of a derivative contract and make the market more stable. With careful supervision and regulation of the margin and other risk management practices of central counterparties, central clearing of a substantial proportion of OTC derivatives should help to reduce risks arising from the web of bilateral interconnections among our major financial institutions. This should help to constrain threats to financial stability.

Second, through capital requirements and other measures, we propose to encourage substantially greater use of standardized OTC derivatives and thereby to facilitate substantial migration of OTC derivatives onto central clearinghouses and exchanges.

We will propose a broad definition of "standardized" OTC derivatives that will be capable of evolving with the markets and will be designed to be difficult to evade. We will employ a presumption that a derivative contract that is accepted for clearing by any central counterparty is standardized. Further attributes of a standardized contract will include a high volume of transactions in the contract and the absence of economically important differences between the terms of the contract and the terms of other contracts that are centrally cleared.

We also will require that regulators carefully police any attempts by market participants to use spurious customization to avoid central clearing and exchanges. In addition, we will raise capital and margin requirements for counterparties to all customized and non-centrally cleared OTC derivatives. Given their higher levels of risk, capital requirements for derivative contracts that are not centrally cleared must be set substantially above those for contracts that are centrally cleared.

Third, we propose to require *all* OTC derivative dealers, and *all* other major OTC derivative market participants, to be subject to substantial supervision and regulation, including conservative capital requirements; conservative margin requirements; and strong business conduct standards. Conservative capital and margin requirements for OTC derivatives will help ensure that dealers and other major market participants have the capital needed to make good on the protection they have sold.

Fourth, we propose steps to make the OTC derivative markets *fully* transparent. Relevant regulators will have access on a confidential basis to the transactions and open positions of individual market participants. The public will have access to aggregated data on open positions and trading volumes.

To bring about this high level of transparency, we will require the SEC and CFTC to impose recordkeeping and reporting requirements (including an audit trail) on all OTC derivatives. We will require that OTC derivatives that are not centrally cleared be reported to a regulated trade repository on a timely basis.

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

Fifth, we propose to provide the SEC and CFTC with clear authority for civil enforcement and regulation of fraud, market manipulation, and other abuses in the OTC derivative markets.

Sixth, we will work with the SEC and CFTC to tighten the standards that govern who can participate in the OTC derivative markets. We must zealously guard against the use of inappropriate marketing practices to sell derivatives to unsophisticated individuals, companies, and other parties.

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

Turning our proposals into law will require that a number of difficult judgments be made. Some of these judgments involve assigning jurisdiction over particular transactions or particular market participants to particular regulatory agencies. We have been working with the SEC and the CFTC over the past few months to develop a sensible allocation of duties. We have made great progress in narrowing the outstanding issues, and intend to send up draft legislation that will provide for a clear allocation of oversight authority between the SEC and CFTC. In making these decisions, we are striving to utilize each agency's expertise, eliminate gaps in regulation, eliminate uncertainty about which agency regulates which types of derivatives, and maximize consistency of the regulatory approach of the two agencies.

Our plan will help prevent the OTC derivative markets from threatening the stability of the overall financial system.

By requiring central clearing of all standardized derivatives and by requiring all OTC derivative dealers and all other significant OTC market participants to be strictly supervised by the federal government, to maintain substantial capital buffers to back up their obligations, and to comply with prudent initial margin requirements, the regulatory framework that we seek to put in place should help lower systemic risk.

Our plan will help make the derivatives markets more efficient and transparent.

By requiring all standardized derivatives to be cleared through regulated central counterparties and executed on regulated exchanges or through regulated electronic trade execution systems and by requiring that detailed information about all types of derivatives be readily available to regulators, our plan will help ensure that the government is not caught—as it was in this crisis—with insufficient visibility into market activity, risk concentrations, and connections between firms.

Our plan will help prevent market manipulation, fraud and other abuses by providing full information to regulators about activity in the OTC derivative markets and by providing the SEC and the CFTC with full authority to police the markets.

Finally, our plan will help protect investors by taking steps to prevent OTC derivatives from being marketed inappropriately to unsophisticated parties.

As Congress moves to craft legislation to reform our financial system, we are moving quickly to advance the overall process.

Following the release of our White Paper on financial regulatory reform in mid-June, we sent up detailed legislative language for the establishment of the Consumer Financial Protection Agency.

We have used the President's Working Group on Financial Markets to pull together all government agencies that oversee elements of the financial system to begin the process of formulating more detailed proposals for implementing the comprehensive reforms outlined by the President.

The SEC is moving forward to put in place new rules to govern credit-rating agencies, which failed to adequately assess the risks of mortgage-backed and other structured securities at the center of the crisis.

The CFTC has announced hearings on whether to impose limits on speculation in energy derivatives in order to dampen price swings, and to require new disclosures by derivative traders.

SEC Chairman Schapiro and CFTC Chairman Gensler were recently on Capitol Hill testifying together about progress in coordinating their agencies' approaches to derivatives and developing a reasonable division of labor in the oversight of these markets.

We welcome the commitment of the Congressional leadership and of the key committees to move forward with legislation this year. This is an enormously complex project. It is important that we get it right. And we need a comprehensive approach.

This crisis caused enormous damage to trust and confidence in the U.S. financial system and to the American economy.

We share responsibility for fixing the system and we can only do that with comprehensive reform.

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