Testimony
of
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Concerning the Wall Street Reform and Consumer Protection Act -- Implementation of Title VII

**Before the
United States Senate
Committee on Agriculture, Nutrition and Forestry**

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Chairwoman Stabenow, Ranking Member Roberts, and Members of the Committee:

Thank you for inviting me to appear before you to discuss the implementation of the derivatives provisions of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Effective and prompt implementation of those provisions is critically important to protect the American public and our financial system.

I recently served as a Commissioner on the Financial Crisis Inquiry Commission ("Commission"), which was created by statute in 2009 to examine the causes of the financial and economic crisis in the United States and to report to the President, Congress and the American people on those causes. The Commission issued its report ("Report") on January 27, 2011, after 18 months of investigation, including 19 days of public hearings, interviews with about 700 persons and review of millions of pages of documents.

The recent financial crisis and the economic crisis that has followed it have demonstrated how vital financial regulatory reform is to the welfare of the American people. As the Commission found, these crises have been devastating. Trillions of taxpayer dollars were committed to rescue large corporations and to support the financial system and the economy. Millions of Americans are out of work, cannot find full-time work or have given up looking for work. Millions of families have lost their homes to foreclosure, are in the foreclosure process, or are seriously behind on their mortgage payments. Trillions of dollars in household wealth vanished, with retirement accounts and life savings swept away. (Report, pp. xv-xvi.)

The Commission concluded that profound failures in financial regulation and supervision along with failures of corporate governance and risk management at major financial firms were among the prime causes of the financial crisis. (Report, pp. xv-xxviii.) The Dodd-Frank Act

addresses a number of the causes of the financial crisis found by the Commission, including the unregulated over-the-counter ("OTC") derivatives market. The Act's full and timely implementation and rigorous enforcement should go far toward protecting the American public.

The Commission in its Report concluded that widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. (Report, p. xviii.) The Commission found that policymakers and regulators failed in their responsibilities to protect the public in part because of a widely accepted belief in the self-regulating nature of financial markets and the ability of financial firms to police themselves. Former Federal Reserve Board Chairman Alan Greenspan championed deregulation and was joined by policy makers in successive Presidential Administrations and successive Congresses in supporting widespread deregulation of financial markets and institutions. As a result, gaps in government oversight of key parts of the financial system were created, including the enormous shadow banking system and the OTC derivatives market. Moreover, supervision of financial firms was weakened, and firms were able in many cases to select among supervisors, leading to a regulatory race to the bottom. The financial sector effectively pressed for this deregulation, spending almost $4 billion in federal lobbying expenses and campaign contributions in the decade leading up to the crisis.

The Commission specifically concluded that unregulated OTC derivatives contributed significantly to the financial crisis. (Report, pp. xxiv-xxv.) It found that the enactment of the Commodity Futures Modernization Act of 2000 "to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward financial crisis." (Report, p. xxiv.) Thereafter, the unregulated global OTC derivatives market grew exponentially to almost $673 trillion in notional amount on the eve of the crisis in June 2008. The Commission found that this market was characterized by uncontrolled leverage,

lack of transparency, lack of capital and margin requirements, speculation, interconnections among firms, and concentrations of risk. The Commission concluded that derivatives known as credit default swaps fueled the securitization frenzy and the housing bubble by encouraging investors in mortgage-related securities to believe they were protected against default. Credit default swaps were also used to create synthetic mortgage-related collateralized debt obligations ("CDOs"), which were merely bets on real mortgage securities. Such bets significantly amplified the losses from the collapse of the housing bubble by allowing multiple bets on the same securities. When the housing bubble burst, derivatives were at the center of the storm. Insurance giant AIG's sale of credit default swaps on mortgage-related CDOs without adequate capital reserves brought it to the brink of failure and necessitated its rescue by the government, which ultimately committed more than $180 billion because of concerns that AIG's collapse would trigger cascading losses throughout the financial system. In addition, the existence of millions of OTC derivative contracts of **all** types -- including interest rate swaps, foreign exchange swaps and commodity swaps -- created interconnections among a vast web of systemically important financial institutions through counterparty credit risk, exposing the financial system to contagion and helping to precipitate the massive government bailouts.

The financial regulatory reforms relating to OTC derivatives contained in Title VII of the Dodd-Frank Act are vital to strengthening the financial system and reducing systemic risk. Centralized clearing by regulated clearing operations will reduce the counterparty credit risk that created contagion during the financial crisis as the failure of financial institutions threatened their counterparties and the financial system as a whole. Trading on regulated exchanges or swap execution facilities will provide critically important transparency and price discovery to market participants and the public. Position limits will reduce excessive speculation on physical

commodities such as energy and agricultural products that distorts price discovery, impairs the use of the markets for hedging purposes, and imposes unfair prices on consumers. Swap dealers will have to meet minimum capital and collateral requirements and will be subject to business conduct rules. Rules against fraud, manipulation and other abuses will protect the marketplace and market participants. Swap data repositories will enable regulators to oversee OTC derivatives as well as those traded on exchange.

The CFTC and the SEC, which have the primary responsibility for implementing Title VII, have been acting responsibly and diligently to propose regulations and to prepare to undertake the enormous new task of regulating the OTC derivatives market -- estimated to approach $300 trillion in notional amount in the United States and more than $580 trillion globally. However, the Act's provisions must be fully implemented by the adoption of regulations and must be rigorously enforced to provide needed protection to the public. Despite all the efforts of the CFTC and the SEC to date, it is important to recognize that safeguards are not yet in place.

There now appears to be a concerted effort by some large financial institutions and their trade associations to prevent full implementation and enforcement of Title VII and other provisions of the Dodd-Frank Act. Alan Greenspan is warning about alleged dire consequences of some provisions of the Act and again advocating self-regulation. Bills are pending in Congress that would repeal or weaken the Act. Efforts to persuade the agencies to issue watered down regulations or to delay or otherwise fail to fully implement provisions of the Act are underway.

Substantial delay of Title VII implementation such as that recently proposed in the House of Representatives would be dangerous. As noted above, until regulations implementing Title VII are in effect, the financial system and the American people will have no protection against the unregulated OTC derivatives market and will continue to be exposed to the repercussions of large defaults which might be triggered by the European sovereign debt crisis, continuing problems in the housing or commercial real estate markets, the vulnerability of the municipal bond market or other significant financial risks. The CFTC has been acting responsibly to ensure that its regulations will be adopted in a timely manner after due consideration of public comments, and additional delay is unwarranted.

Some financial services firms are arguing that the rules will be too burdensome and costly and that they will be "job killers." Yet, any such impact of the rules will be miniscule compared to the trillions of dollars of lost wealth and taxpayer expenditures and the millions of lost jobs that the lack of regulation caused during the financial crisis. Failure to regulate OTC derivatives now would risk another crisis involving enormous costs to the public.

Firms are also arguing that U.S. regulation under the Dodd-Frank Act might cause them to conduct their derivatives transactions on foreign markets with less regulation than the United States. This argument merely underscores the importance of international cooperation in establishing comprehensive reform of the derivatives market as called for by Secretary of the Treasury Timothy Geithner in his speech on June 6, 2011 to the International Monetary Conference.

Moreover, Congressional threats to cut the funding of key regulators imperil regulatory reform. The CFTC has been threatened with cuts that would significantly impair its operations.

As noted above, it has greatly increased responsibilities under the Dodd-Frank Act -- responsibilities vital to financial stability -- and needs significantly more resources to meet those responsibilities. The reduction in the CFTC's fiscal year 2012 budget proposed in the House of Representatives would not only impede the CFTC's ability to implement regulations under Title VII but would stifle its ability to enforce them.

The political power of the financial sector is still enormous, and policy makers in Congress and the Executive Branch must have the political will to resist these efforts to derail regulatory reform. If we do not learn from the financial crisis and put in place the regulatory reforms needed to address its causes, we may well face future financial crises. The American people deserve better.

Thank you very much.