U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

SPEECHES & TESTIMONY

Remarks of Chairman Gary Gensler before the FIA's 2013 - 38th Annual International Futures Industry Conference

March 13, 2013

Good morning. Jeff, I appreciate that kind introduction. I thank the Futures Industry Association (FIA) for inviting me to speak for my fourth time at this conference.

Before getting started, I'd like to thank Commissioners Sommers, Chilton, O'Malia and Wetjen for their hard work and dedication to improving the markets.

I particularly want to express my appreciation to Jill, who recently announced that she will be leaving the Commission. We will all miss Jill.

She has worked to bring common-sense swaps market reforms to life and to safeguard the integrity of the futures market. Over the last four years, all of the nearly 900 Commission actions we've taken together have benefited from her thoughtful input. Though we're in a town not often known for it, the vast majority of these actions were achieved through consensus.

The New Era of Swaps Market Reform

It's been an exciting time since this conference one year ago.

Last year, the swaps market was still unregulated. This year, swaps market reform is a reality.

Last year, the swaps market remained largely in the dark. This year, transparency has come to the market with the price and volume of transactions available to the public like a modern-day ticker tape.

Last year, we were talking about when the Commodity Futures Trading Commission (CFTC) would vote on entity and product definition rules. This year, 73 swap dealers and two major swap participants are provisionally registered.

Last year, we were talking about when the "T" of required clearing would start. This year, we meet the same week that required clearing has begun. In just the first two days of required clearing, there has been over half a trillion dollars of customer or buyside clearing.

Last year, market participants were still debating customer protection enhancements.

This year, many important enhancements have been implemented, including gross margining, the so-called "LSOC" rule (legal segregation with operational comingling) and new National Futures Association rules. The Peregrine situation last summer, however, further highlighted that there is more yet to be done.

Last year, few who attended this conference were focusing on the reliability of LIBOR and other similar benchmarks. This year, the public has seen how readily and pervasively LIBOR and similar rates have been rigged.

In the last year, we've seen some realignment of swaps and futures as both IntercontintalExchange and CME Group have converted the trading of energy swaps to now being offered for trading as energy futures.

And last year, we had yet to learn that an entrepreneurial startup derivatives platform, born just 13 years ago, would announce the purchase of the over 200-year-old New York Stock Exchange.

A remarkable year indeed.

A year in which participants in the futures and swaps markets have adapted to significant change.

This year is likely to be exciting as well. Implementation of common-sense reforms for the swaps market is being phased in over the course of the year. Clearing will continue to be phased in through September. Swap dealers increasingly will come into compliance with business conduct standards. And transparency will be further enhanced as additional market participants report their transactions.

Pre-trade transparency

Looking forward, it's a priority that the Commission finishes rules to promote pre-trade transparency, including those for swap execution facilities (SEFs) and the block rule for swaps.

Pre-trade transparency will allow buyers and sellers to meet and compete in the marketplace, just as they do in the securities and futures marketplaces. SEFs will allow market participants to view the prices of available bids and offers prior to making their decision on a transaction.

Transparency – a longstanding hallmark of the futures market, both pre- and post-trade – lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition.

Further Implementation of Swaps Market Reform

Looking forward, it's a priority that the Commission ensures the cross-border application of swaps market reform appropriately covers the risk of U.S. affiliates operating offshore. During a default, risk knows no geographic border.

If a run starts in one part of a modern financial institution, whether it's here or offshore, the risk comes back to our shores. That was true with AIG, which ran most of its swaps business out of the London neighborhood Mayfair. It was also true at Lehman Brothers, Citigroup, Bear Stearns and Long-Term Capital Management.

Thus, as the CFTC completes the cross-border guidance, I believe it's critical that Dodd-Frank swaps reform applies to transactions entered into by branches of U.S. institutions offshore, between guaranteed affiliates offshore, and for hedge funds that are incorporated offshore but operate in the U.S. Where there are comparable and comprehensive home country rules abroad, we can look to substituted compliance, but the transactions would still be covered.

Otherwise, American jobs and markets may move offshore, but, particularly in times of crisis, risk would come crashing back to our economy.

The Commission granted time-limited relief until this July for non-U.S. swap dealers (and foreign branches of U.S. swap dealers) from certain Dodd-Frank swap requirements.

In July, when the relief expires, various Dodd-Frank requirements will apply to non-U.S. swap dealers. Overseas financial institutions that wish to look to substituted compliance to fulfill Dodd-Frank requirements are encouraged to engage now with the CFTC, as well as their home country regulators.

Customer Protection

Building on the significant steps market participants and the Commission has taken on customer protection, the CFTC staff is now reviewing public comments on our recent proposal for further enhancements.

The proposal includes a provision on residual interest to ensure that the assets of one customer are not used to cover the positions of another customer. We are considering the many comments we have received on this and plan to finalize the proposal consistent with

the specific provisions of the Commodity Exchange Act and the overall goal of protecting customers.

LIBOR

As important as the continued implementation of swaps market reform and finalizing customer protections will be this year, the work we do related to LIBOR and similar rates is likely to be just as critical.

There is a growing recognition that the financial system's reliance on interest rate benchmarks, such as LIBOR and Euribor, is particularly fragile.

I believe that continuing to reference LIBOR and similar benchmark rates is unsustainable in the long run. A reference rate has to be based on facts, not fiction.

Let's look at what we've learned to date.

First, the interbank, unsecured market to which LIBOR and other such rates reference has changed dramatically. Some say that it is has become essentially nonexistent.

In 2008, Mervyn King, the governor of the Bank of England, said of LIBOR: "It is, in many ways, the rate at which banks do not lend to each other." He went on further to say: "[I]t is not a rate at which anyone is actually borrowing."

There has been a significant structural shift in how financial market participants finance their balance sheets and trading positions. There is an increasing shift from borrowing unsecured (without posting collateral) toward borrowings that are secured by posting collateral.

The London interbank, unsecured market used to be where banks funded themselves at a wholesale rate. But the 2008 financial crisis and subsequent events have shattered this model.

The European debt crisis that began in 2010 and the downgrading of large banks' credit ratings have exacerbated the hesitancy of banks to lend unsecured to one another.

Other factors have played a role in this structural shift. Central banks are providing significant funding directly to banks. Banks are more closely managing demands on their balance sheets. Looking forward, recent changes to Basel capital rules will take root, making it unlikely that banks will lend to each other unsecured for three months, six months or a year.

The Basel III capital rules now include an asset correlation factor, which requires additional capital when a bank is exposed to another bank. This was included to reduce financial system interconnectedness.

Furthermore, the rules introduce a liquidity coverage ratio (LCR). For the first time, banks will have to hold a sufficient amount of high quality liquid assets to cover their projected net outflows over 30 days.

One major bank has indicated that the LCR rule alone would make it prohibitively expensive for banks to lend to each other in the interbank market for tenors greater than 30 days.

Second, LIBOR – central to borrowing, lending and hedging in our economy – has been readily and pervasively rigged.

Barclays, UBS and RBS were fined approximately $2.5 billion for manipulative conduct by the CFTC, the U.K. Financial Services Authority (FSA) and the U.S. Justice Department.

At each bank, the misconduct spanned many years.

At each bank it took place in offices in several cities around the globe.

At each bank it included numerous people – sometimes dozens, and even senior management.

Each case involved multiple benchmark rates and currencies. In each case, there was

evidence of collusion.

In the UBS and RBS cases, one or more inter-dealer brokers painted false pictures to influence submissions of other banks, i.e., to spread the falsehoods more widely.

Barclays and UBS also were reporting falsely low borrowing rates in an effort to protect their reputation.

Thirdly, we have seen a significant amount of publicly available market data that raises questions about the integrity of LIBOR today.

A comparison of LIBOR submissions to the volatilities of other short-term rates reflects that LIBOR is remarkably more stable than any comparable rate. For instance, how is it that in 2012 – if we look at the 252 submission days for three-month U.S. dollar LIBOR – the banks didn't change their rate 85 percent of the time?

When comparing LIBOR submissions to the same banks' credit default swaps spreads or to the broader markets' currency forward rates, why is there a continuing disconnect between LIBOR and what those other market rates tell us?

While ongoing international efforts will focus on principles for benchmarks, including governance, conflicts of interest and their administration, these efforts can do little to address the key weakness of these benchmarks: the absence of real transactions underpinning the reference rate.

Given what we know now, market participants and regulators around the globe have begun to discuss two critical questions:

• First, what best alternatives anchored in real transactions are there to LIBOR, Euribor and other similar benchmarks?

• And second, what are the mechanisms and protocols for the financial system and market participants to transition to reliable alternatives?

The International Organization of Securities Commissions Task Force on Financial Market Benchmarks stated in its January consultation with the public: "The Task Force is of the view that a benchmark should as a matter of priority be anchored by observable transactions entered into at arm's length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values."

I agree with this.

There are alternatives that are grounded in real transactions. These include the overnight index swaps rate, benchmark rates based on actual short-term collateralized financings, and benchmarks based on government borrowing rates.

The second question is already upon us. Martin Wheatley of the FSA recommended Canadian dollar LIBOR and Australian dollar LIBOR will cease to exist. Far more challenging is addressing possible transition from U.S. dollar LIBOR, Euribor and other widely referenced benchmarks.

The market has some experience with transition, albeit for smaller contracts, such as for energy and shipping rate benchmarks. The basic components of such transitions have included:

• Identifying a reliable alternative benchmark, one that is anchored in transactions;

• Allowing the new and existing benchmarks to run in parallel for a period of time to allow market participants to transition; and

• Discontinuing, at some point, the unreliable or obsolete benchmarks.

I recognize that moving on from LIBOR and Euribor may be challenging. It may be unpopular. But continuing to support LIBOR and Euribor to maintain stability – particularly as the interbank, unsecured market is essentially nonexistent – may only create more instability in the end.

I believe it best not to fall prey to accepting that LIBOR or any benchmark is "too big to replace."

The American financial system has always been and will continue to be resilient. The American financial system has proven time and again it can adapt.

Resources

For all the accomplishments of the last year, there's one thing that hasn't kept up with the changing markets.

Today, the CFTC has fewer people than we did one year ago. And with sequestration, our funding has actually declined since last year.

At 684 people, we are just 7 percent larger than we were 20 years ago, but we now oversee the vast swaps market that is eight times the size of the futures market. And the futures market has grown significantly since then as well.

Simply put, the CFTC is not the right size for the new and expanded mission Congress has directed it to perform.

We need significantly more people and investments in technology for examinations, to vigorously pursue enforcement cases, and to handle applications for registration.

We need significantly more people to be responsive to the hundreds of incoming questions and requests regarding implementation of reform.

Without sufficient funding, your businesses – and the nation – cannot be assured that this agency can adequately oversee the futures and swaps markets.

Conclusion

In the last year, there have been significant and exciting changes for the futures and swaps markets.

I think there is a lot for all of you to be proud of in adapting to these changes. The public will be better protected and will benefit from greater transparency.

There is certainly more to do.

But despite any challenges ahead, I know that derivatives markets – dating back to the 1860s, and an essential component of our American financial system – will continue to grow and thrive.

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