

## SPEECHES & TESTIMONY

### Remarks of Chairman J. Christopher Giancarlo at the Association of German Banks, Berlin, Germany

May 7, 2018

Thank you, Andreas Krautscheid for that kind introduction. I also wish to thank the Bankenverband for hosting this event. Good afternoon. Thank you all for coming.

It is good to be in Berlin.

My last name is Italian. However, my mother's maiden name is German: *Schwarz*. My great-great grandfather, Josef Alfons Schwarz, taught pharmacology at Humboldt University here in Berlin over a hundred and twenty-five years ago.

#### Introduction

Just as it was then, today Berlin is a dynamic, energetic, influential and vibrant city at the heart of Europe. It is a powerful center of culture, finance, trade and commerce.

As members of this Association, many of you are directly responsible for Berlin's rebirth through strong and resilient and responsible banking practices. German banking has helped the world overcome the turbulence of 2008 and recover from the Great Recession. You are essential to Germany's global economic leadership. And, I know you want future stability, order and opportunity.

Two weeks ago, there was much talk about Germany in America. The German flag was flying in Washington, which hosted Chancellor Angela Merkel and other German officials. In the financial press there were articles about trade, banking, cybersecurity and bi-lateral cooperation. Chancellor Merkel's visit was an opportunity to review our relationship and discuss issues that need to be addressed. It is a time for, what one commentator called, a "sifting of ideas" to use our strong ties to concentrate on core principles and resolve differences.

I have come to Berlin in that same spirit of respect, reciprocity and partnership. I want to discuss some crucial issues for both of our countries. I invite your thoughts and response.

#### Cross Border Regulatory Cooperation

As the regulator for U.S. derivatives markets, the world's largest, I am very aware that the rules and regulations adopted in the United States impact firms around the world, including financial institutions here in Germany. Therefore, it is important that you know that I am committed to cross border regulatory harmonization.

The Duff and Phelps 2018 Global Regulatory Outlook Survey found, among the financial executives surveyed, **19 percent of executives called greater harmonization among regulations** the "single most important factor in maintaining an effective regulatory system." Fortunately, 52 percent believe regulators are improving their ability to collaborate with peer across borders. Almost one-third said the effort has led to greater harmonization and consistency in global regulations.

Cross-border harmonization entails creative approaches and flexibilities that honor differing legal regimes while permitting and enhancing market collaboration across borders and ensuring our markets remain strong and resilient. I am committed to outcomes-based deference decisions

that acknowledge that different regulators can get to the same result in different ways. Different regulators use different legal frameworks and different legal tools, and we need to respect such differences when they achieve similar regulatory outcomes.

We need greater harmonization. We also need to be consistent, reasonable, and cost-efficient. I have expressed concern over the current European Union (EU) legislative proposal for a new framework for the regulation and supervision of central clearing counterparties (CCPs). I have the highest respect for Germany's BaFin and other European authorities. My concern lies with parts of the EU proposal that would subject U.S. CCPs to overlapping EU regulation and supervision without due deference to CFTC regulation and supervision – due deference that was already agreed to between the EU and the United States in the 2016 common approach for transatlantic CCPs. We spent three years working on that agreement and remain committed to it. We do not want to renegotiate it.

As Bundesbank Board member Andreas Dombret and others have said, there is no need to alter this already robust arrangement concerning U.S. CCPs. We have been supervising them for decades. The CFTC's requirements for CCPs, like the EU's, are based on agreed upon international principles. Additional regulation is unnecessary and adds to confusion and cost. The arrangement is working now. I hope this issue does not divide the United States and Europe. Regulatory and supervisory deference is the path upon which the United States and Europe should journey together.

### **Utility of Global Swaps Markets**

Let me now turn to the swaps market. As you know, swaps and other derivatives help stabilize the cost of living for our citizens. They serve the needs of society to help moderate price, supply and other commercial risks to free up capital for economic growth, job creation and prosperity. They allow the risks of variable production costs, such as the price of raw materials, energy, foreign currency, and interest rates, to be transferred from those who cannot afford them to those who can. While often derided in the tabloid press as “risky,” derivatives – when used properly – are tools for efficient risk transfer and mitigation. More than 90 percent of *Fortune* 500 companies use derivatives to manage commercial or market risk in their worldwide business operations.

And yet, global derivatives markets have not always performed as well as they should.

### **Global Reform Initiative**

Ten years have passed since the start of the 2008 financial crisis. In September 2008, Lehman Brothers filed for Chapter 11 bankruptcy protection. Its failure was a consequence of the bursting of a double bubble of housing prices and consumer credit, as lenders became concerned about a fall in property values and repayment of mortgages. An extraordinary “run-on-the-bank” ensued with rapidly falling asset values preventing U.S. and foreign lenders from meeting their cash obligations. This marked the beginning of a financial crisis that was devastating for far too many businesses and families.

Over-the-counter (OTC) derivatives contributed to the financial crisis through American International Group's (AIG) writing of credit default swaps (CDS) protection on mortgage products – a substantial part of AIG's failure – and through synthetic mortgage collateralized debt obligations (CDOs), which had made their way onto bank balance sheets. Perhaps most important, however, was the lack of reliable information about OTC derivatives positions contributing to the “fog of war.” Very simply, government authorities did not have the data to accurately assess the implication of the failures of Bear Stearns, Lehman Brothers and AIG on derivatives counterparties throughout the financial system.

It became clear that financial market regulatory reform was needed.

At the 2009 Pittsburgh G-20 Summit, global leaders agreed to work together to support economic recovery through a “Framework for Strong, Sustainable and Balanced Growth.” They pledged to work together to “implement global standards” in financial markets, while rejecting “protectionism.”

The G-20 leaders agreed upon several fundamental principles to reform OTC derivatives markets, namely: regulation of swaps trading and execution, reporting of swaps transactions, increased central counterparty clearing of swaps transactions, and swap dealer capital requirements.

The United States moved first, with Congress enacting many of the Pittsburgh reforms into law under Dodd-Frank in 2010. Among U.S. regulators, the Commodity Futures Trading Commission (CFTC) was given responsibility given to regulate most swaps under Title VII of Dodd-Frank. It has been the most active, implementing most of the swaps reforms by 2014. In Europe, swaps market reform was first implemented in the form of EMIR in 2012, to be followed by MIFID II, much of which first came on line at the start of 2018.

We now have more than four years of U.S. experience with the current CFTC regulatory framework for swaps, and have learned from its varied strengths and shortcomings. Four years provides a significant sample size to evaluate the effects of these reforms and their implementation. Based on a careful analysis of that data and experience, we are in position to address flaws, recalibrate imprecision and optimize measures in the CFTC’s initial implementation of swaps market reform.

In many ways, regulatory frameworks are like software applications. Their value can be enhanced by addressing flaws, improving security, meeting additional requirements, becoming easier to use, more efficient, accommodating newer technology, and expanding the user base. The goal is to preserve the value of the core regulatory framework over time.

Like software users, market participants will always look to participate in well-designed, regulatory frameworks. I do not subscribe to the “race to the bottom” thesis of comparative regulation. It is based on a naïve understanding of trade and commerce. Frankly, it is insulting to the responsible businessmen and women who build and operate our modern economy. Trading counterparties seek neither the least nor the most regulated marketplaces, but marketplaces that have the right balance of sensible, objective and well-maintained regulation – in other words: good software.

And just as with software, the details of regulatory frameworks matter. There inevitably will be flaws and bugs in the first release of major software. It has to be improved and maintained. Reasonable adjustments and fixes can make dramatic improvements in the effectiveness of regulations.

I believe that market regulators have a duty to apply broad policy prescriptions in ways that enhance markets and their underlying vibrancy, diversity and resiliency. That duty also includes the responsibility to continuously review past policy applications to confirm they remain optimized for the purposes intended. It further includes anticipating changing market dynamics and the impact of technological innovation.

### **White Paper: “Regulatory Reform 2.0.”**

Two weeks ago I released a White Paper on swaps reform called “Regulatory Reform 2.0.” The White Paper was co-authored with Bruce Tuckman, the CFTC’s Chief Economist. This White

Paper analyzes the range of academic research, market activity and regulatory experience with the CFTC's current implementation of swaps reform. It explores and considers a range of improvements to the current reform implementation that is pro-reform, aligned to legislative intent and better balances systemic risk mitigation with healthy swaps market activity in support of broad-based economic growth.

The White Paper assesses the CFTC's implementation of Dodd-Frank swaps reforms in the areas of central counterparty clearing, trade reporting, trade execution, swap dealer capital and the end user exception. It looks both at areas of success and recognized shortcomings. In numerous areas, it makes considered recommendations for improvement. Let me summarize it for you.

### **Swaps Central Counterparties**

Swaps clearing was probably the most far-reaching and consequential of the G-20 swaps reforms. The Bank for International Settlements (BIS) estimated that minimum global clearing rates at the time of the financial crisis was about 40% for interest rate swaps and 8% for credit default swaps. By 2017, about 85% of new interest rate swaps and credit default swaps were being cleared. The default risk of swaps counterparties that was once spread across Wall Street is now pooled and managed within regulated CCPs.

Unquestionably, the CFTC's swaps clearing mandate was highly successful. Its success, however, has significantly increased the volume of swap transactions cleared through CCPs and has led to a number of considerations for further deliberation.

The first consideration is to ensure that CCPs are safe and sound under extreme but plausible conditions. Each CCP runs a perfectly "matched book," meaning that they take zero market risk. They do face the risk, however, that clearing members default at the same time they lose value in their cleared positions. Against this risk, CCPs operate under CFTC supervision to carefully scrutinize member creditworthiness, collect calibrated resources against potential losses, and undergo rigorous regulatory examinations.

There is room for further analysis, however, along several dimensions: ensuring the liquidity of funded resources, understanding correlated defaults and network effects, and properly accounting for liquidation costs (particularly for new products).

The second consideration is with respect to recovery plans, which describe how a CCP, in extreme adverse scenarios, would comprehensively allocate losses, restore its matched book and replenish its financial resources. A great deal of progress has been made here as well, but some issues remain: the transparency and predictability of recovery plans and the role of unfunded resources, namely, assessments.

Third, there are considerations related to resolution by government authorities, in the event that recovery plans prove inadequate. This would be a very extreme scenario, in which the financial system would almost certainly have greater and more pressing problems than derivatives clearing, but prudence dictates that such plans be ready and as transparent as possible.

### **Swaps Reporting Rules**

I turn to the trade reporting mandate. A critical fact of the 2008 financial crisis was the inability of regulators to assess and quantify the counterparty credit risk of large banks and swap dealers. Of all the swaps reforms to emerge from the financial crisis, visibility into counterparty credit risk of major financial institutions was perhaps the most pressing. The regulatory failure to complete it is certainly the most disappointing.

Despite the hard work and effort that has gone into establishing swap data repositories (SDRs) and supplying them with swaps data, a decade after the financial crisis, SDRs still cannot provide regulators with a complete and accurate picture of counterparty credit risk in global swaps markets.

In part, the problem has been faulty implementation by regulators, including the CFTC. The CFTC's initial approach to swaps reporting provided insufficient technological detail and specification. Instead, it relied on industry participants to utilize standardized nomenclature and data protocols, assuming the existence of a similar degree of standardization of swaps market data that exists in futures markets. Since then, substantial progress has been made here and abroad by both regulators and market participants in standardizing data nomenclature, reporting elements and reporting protocols.

The CFTC is committed to success in the global reform efforts towards swaps data reporting. That means devoting high-level resources and effective project management to complete the process of data standardization and cross-border harmonization. It also means extensive dialogue and coordination with industry participants and overseas regulatory counterparts.

### **Swaps Execution Rules**

Let me now address the trade execution mandate: Congress enacted the G-20 swaps execution reforms in the Dodd-Frank Act by requiring that swaps transactions be traded on regulated platforms called swap execution facilities (SEFs) and executed by "any means of interstate commerce." There is no requirement in U.S. law for electronic execution. Unfortunately, in its first draft, the CFTC incorrectly implemented some of this reform. It grafted into its SEF rules a number of market practices from highly liquid futures markets that are antithetical to episodically liquid swaps trading. The CFTC limited methods of swaps execution in a misinformed attempt to re-engineer the market structure of swaps execution.

To use software terminology, these features are a significant design flaw. They have led to harmful market fragmentation, a systemic risk. Instead of establishing the SEF regulatory construct to be salutary to liquidity formation, CFTC rules turned SEFs into environments that are un conducive to it. One effect has been to shift swaps price discovery and liquidity formation away from SEFs to platforms that are not subject to conduct and compliance requirements appropriate for swaps products.

### **Swap Dealer Capital**

The White Paper next addresses swaps dealer capital requirements. While the debate has not been conclusively settled, the emerging consensus seems to have endorsed the principle of risk-based capital requirements. However, because regulators have not allowed regulator-approved internal models in all cases, many parts of the current regime are biased against swaps.

The particular problems of standardized, regulatory capital models arise from inappropriately relying on swap notional amount to measure risk, from not sufficiently recognizing offsetting swap positions between pairs of counterparties, and from not sufficiently acknowledging the risk-mitigation of posted margin. These appear to be unintended consequences of swaps market reform, and should be corrected.

One approach to correcting the problem is to continue to refine, and by necessity complicate, the standardized models imposed on market participants. A better approach may be to ascertain how regulators might rely more heavily, but confidently, on the internal risk models used by banks and their swap dealer affiliates.

## End User Exception

Finally, the White Paper covers end users of swaps. The Dodd-Frank Act required various market participants to clear standardized swaps and required swap dealers to collect margin on uncleared swaps. The benefits of these requirements, with respect to reducing systemic risk, were judged to be worth the concomitant costs.

At the same time, Dodd-Frank exempted commercial end users from these requirements through a legislative arrangement known as the “end user exception.” These market participants are not sources of systemic risk and would find the requirements particularly costly.

The fate of many financial end users, by contrast, was not as definitive, particularly with respect to uncleared margin requirements. Smaller financial end users should be exempt from clearing and margin requirements through a material swaps exposure threshold, for the same reasons that commercial end users are exempt. Larger financial end users, on the other hand, that can very well be sources of systemic risk, should remain subject to the clearing and uncleared margin requirements.

Uncleared margin rules can and should achieve their objectives without being as prescriptive as currently constructed. A less prescriptive approach would both encourage sound and innovative risk management and be less likely to encourage model herding, itself a source of systemic risk.

## Conclusion

The essential role of global derivatives markets are to help mitigate price, supply and other commercial risks – shifting risk to those who can best bear it from those who cannot. Thus, well-functioning global derivatives markets free up capital for business lending and investment necessary for economic growth. Flourishing derivatives markets underpin global economic health. We must foster safe, sound and vibrant global markets for investment and risk management to stimulate greater job creation and broad-based prosperity both in America and in Europe.

Market regulators have a duty to apply the policy prescriptions of their legislatures in ways that enhance markets and their underlying vibrancy, diversity and resiliency. That duty also includes the responsibility to review past policy applications continuously to confirm they remain optimized for the purposes intended. It further includes anticipating changing market dynamics and the impact of technological innovation.

My White Paper analyzes and considers the CFTC’s particular implementation of swaps reform from a perspective that is strongly aligned with the G20 reforms. It seeks to better balance market durability and systemic risk mitigation with healthy trading liquidity necessary for broad-based economic growth and revival. Its purpose is to establish a vision for a continuous process of improvement to swaps market reform.

To ensure the global success of these reforms, we will rely on pragmatic cross-border principles of deference, comity and cooperation to guide CFTC rulemaking and staff actions. These principles will address market fragmentation, contraction of liquidity, market disruption and dislocation in the global derivatives markets.

We must not be afraid to make appropriate adjustments. With better calibration, we can make these markets more vibrant, successful and accessible while reducing systemic risk. Safe and robust swaps markets must underpin economic growth and prosperity, which of course, enhance the human condition.

I will finish my formal remarks by turning to the well-known remarks by President John Kennedy:

I will finish my formal remarks by turning to the well-known remarks by President John Kennedy here in Berlin, fifty-five years ago next month. He spoke of the importance of Berlin in the “advance of freedom everywhere.” He asked us to lift our eyes to the “hopes of tomorrow.” He said that if we wanted to see a future of prosperity, democracy and freedom, “Let them come to Berlin.”

And, President Kennedy said something else. He said any free person, wherever he may be, is an honorary citizen of Berlin.

If so, then as a free man, I take pride in that honorary citizenship, that linkage across the years and history and geography, this association, this solidarity, this timeless hard-won force of freedom.

Thank you.