Americans for Financial Reform
Accountability, Fairness, Security

Support Strong Derivatives Regulation

Over-the-Counter Derivatives Markets Act of 2009 (H.R. 3795)

Congress cannot protect the U.S. financial system without acting to regulate over-the-counter derivatives, which brought down AIG at a cost of $134 billion to taxpayers. The five biggest banks dominate the derivatives market and want to maintain the status quo, since opaque markets permit them to charge very high fees to derivatives clients. Unregulated derivatives encourage excessive leverage and unacceptable levels of risk in the economy. Taxpayers, consumers of energy and other commodities, and commercial enterprises using derivatives to hedge, are the losers.

Derivatives are securities whose price is dependent upon (or derived from) one or more underlying assets. These assets include physical commodities (oil, wheat); and financial instruments (stocks, bonds, currencies). Calls, puts, swaps, and futures are all types of derivatives. They serve an economic purpose by permitting businesses to predetermine the prices of key production inputs and outputs.

Prior to 2000, standardized derivatives were required to be exchange-traded. The Commodities Futures Modernization Act of 2000 provided two large loopholes and gave rise to the over-the-counter (OTC) derivatives market. The first OTC trade was in 1997 and the market has since ballooned to $600 trillion.

AIG Financial Products sold a type of OTC derivative called a credit default swap (CDS) which transfers the risk of a negative credit event from the buyer to the seller, in exchange for a periodic protection fee similar to an insurance premium. AIG issued credit default swaps to cover the credit risk of bundled subprime loans, not only incurring unsustainable risk but also fueling the housing price bubble. Taxpayers bore the cost when $134 billion was paid out to AIG's counterparties.

AFR urges Congress to ensure that any legislation passed requires all standard derivatives to trade on an exchange, including foreign currency derivatives Because derivatives market participants are "too interconnected to fail" any exception to this policy risks rendering the legislation of little use.

Returning derivatives to an open exchange is a common sense solution to the risky bets that were made with our money. We have been using exchanges for hundreds of years for financial products, because they allow market participants to see pricing information in real time, and allow both regulators and participants to take note if a dealer is taking on excessive risk. Most derivatives currently called "customized" are transacted on copyrighted boilerplate documentation, so would lend themselves to standardized exchange trading.

The largest swaps dealers are the five "too big to fail" banks, and they expect to earn $35 billion from opaque derivatives trades this year. Remarkably, these banks have convinced their customers that a return to transparency would be bad for them.[1] Since the banks' credibility is damaged, they have sent their corporate customers, known as "derivatives end users" to lobby on their behalf.[2] The US economy cannot afford another derivatives meltdown.

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[1] "Keeping Derivatives in the Dark," *New York Times*, Floyd Norris, November 27, 2009.
[2] "The Money Man's Best Friend," *The Nation*, William Greider, November 11, 2009.