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Garrett Opening Statement for Financial Services Derivatives Hearing

(Washington, DC)– **Rep. Scott Garrett (R-NJ)** released the following opening statement for today’s House Financial Services Subcommittee on Capital Markets hearing entitled “The Effective Regulation of the Over-the-Counter Derivatives Markets”:

“Thank you Mr. Chairman and good morning to our witnesses.

“Today’s hearing title is: “The Effective Regulation of the Over-the-Counter Derivatives Markets.” That’s important to keep in mind. The title is NOT, “The Most Politically Correct Sounding Regulation of Derivatives.” Nor is it, “Let’s Regulate the Heck out of the Derivatives Markets Because They’ve Been Demonized, and Let’s Ignore all the Positive Contributions They Make to our Capital Markets and to Proper Risk Management.”

“Unfortunately, with some of the regulatory proposals that have come forward in this area, you might think that was the approach that was being taken.

“94% of the 500 largest global companies use derivatives to manage risk. Congress, therefore, needs to tread carefully as it looks at regulatory options for these markets. Over-regulation or improper regulation that might sound good politically could have major unintended negative consequences, not just for our financial markets, but for our broader economy.

“Rather than reducing risk, poor regulatory “reform” could exacerbate it.

“Before we go any further, it’s important to remember that derivatives did not cause our financial difficulties. In fact, they should be seen more as a symptom of the underlying crisis, rather than a reason for it.

“While our overall financial services regulatory structure can be improved, it is important to preserve and protect the important benefits these financial contracts provide for American businesses. Derivative products provide firms with the ability to minimize risk – this obviously benefits individual firms, but it also benefits our broader markets as well as individual consumers by protecting against food and energy price spikes, for example.

“As members of Congress consider reform proposals, we must not be overwhelmed by the fact that one high profile financial institution, AIG, made a bad investment decision, using derivatives to guarantee mortgages that went sour. We must also keep in mind that this occurred while AIG was under the supervision of its regulator, the Office of Thrift Supervision, and was part of the broader regulatory failure in the housing finance sector.

“Greater expertise in some cases is required at the functional regulator level for derivatives dealers, but AIGFP WAS a regulated entity. And the AIG case is a reminder that regulatory failure contributed to our financial crisis as much as anything.

“Furthermore, the vast majority of exposure in the CDS market, for instance, is contained within the already heavily-regulated banking sector. Arguably everything is in place already for regulators to appropriately regulate the bulk of this market that is dominated by a small number of dealers. Regulators already have oversight responsibilities to ensure firms are taking appropriate risks and to set proper capital levels. The power is there. Regulators, however, need to do their jobs.

“When there have been credit events, and there have been a number of notable ones over the last year, with the Lehman failure perhaps the most significant, each event has been handled in a very orderly fashion by the existing OTC infrastructure.

“As I look at some of the particular regulatory ideas that have been put forward, I am persuaded that central counterparties and clearinghouses hold promise, but I am very hesitant to go so far as to say that there should be mandatory central clearing for so-called “standardized products”.

“The private sector has made significant progress in a relatively short period of time toward having multiple central clearinghouses for various derivatives markets. Having central clearing available will provide incentives for parties to participate in these facilities. Introducing the concept of mandatory participation is where you enter into the realm of unintended consequences.

“Inappropriate mandating of central clearing will limit the ability of end-users to properly manage their risk.

“Proposals to ban so-called “naked swaps” also are concerning. Again, it’s important that legislators understand the significant negative consequences that will arise if such a proposal actually was enacted.

“The participants and infrastructure providers in the OTC markets have accomplished much in recent years to provide stability – from the ISDA Master Agreement to the recent so-called “Big Bang Protocol”, to ongoing efforts to provide a more robust infrastructure for these products.

“I look forward to continued progress being made in regards to greater coordination between sell-side and buy-side participants as private sector efforts progress to increase efficiency and transparency and reduce risks in the OTC derivatives business.

“As Congress pushes forward with further regulation in these markets, we need to guard against unnecessary and overly burdensome regulations that might cause markets to move overseas or that

would hinder or prohibit firms from providing themselves with the superior risk management techniques that are so widely employed today and that could be enhanced by future innovations.”

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