AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

HEARING TO EXAMINE THE REGULATION OF OVER-THE-COUNTER DERIVATIVES

JOINT HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE

AND THE

COMMITTEE ON FINANCIAL SERVICES HOUSE OF REPRESENTATIVES

FIRST SESSION

JULY 10, 2009

Serial No. 111–23
(COMMITTEE ON AGRICULTURE)
Serial No. 111–55
(COMMITTEE ON FINANCIAL SERVICES)

Printed for the use of the Committee on Agriculture
agriculture.house.gov

U.S. GOVERNMENT PRINTING OFFICE

53–021 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON AGRICULTURE

COLLIN C. PETERSON, Minnesota, *Chairman*

TIM HOLDEN, Pennsylvania, *Vice Chairman*
MIKE McINTYRE, North Carolina
LEONARD L. BOSWELL, Iowa
JOE BACA, California
DENNIS A. CARDOZA, California
DAVID SCOTT, Georgia
JIM MARSHALL, Georgia
STEPHANIE HERSETH SANDLIN, South Dakota
HENRY CUELLAR, Texas
JIM COSTA, California
BRAD ELLSWORTH, Indiana
TIMOTHY J. WALZ, Minnesota
STEVE KAGEN, Wisconsin
KURT SCHRADER, Oregon
DEBORAH L. HALVORSON, Illinois
KATHLEEN A. DAHLKEMPER, Pennsylvania
ERIC J.J. MASSA, New York
BOBBY BRIGHT, Alabama
BETSY MARKEY, Colorado
FRANK KRATOVIL, Jr., Maryland
MARK H. SCHAUER, Michigan
LARRY KISSELL, North Carolina
JOHN A. BOCCIERI, Ohio
SCOTT MURPHY, New York
EARL POMEROY, North Dakota
TRAVIS W. CHILDERS, Mississippi
WALT MINNICK, Idaho

FRANK D. LUCAS, Oklahoma, *Ranking Minority Member*
BOB GOODLATTE, Virginia
JERRY MORAN, Kansas
TIMOTHY V. JOHNSON, Illinois
SAM GRAVES, Missouri
MIKE ROGERS, Alabama
STEVE KING, Iowa
RANDY NEUGEBAUER, Texas
K. MICHAEL CONAWAY, Texas
JEFF FORTENBERRY, Nebraska
JEAN SCHMIDT, Ohio
ADRIAN SMITH, Nebraska
ROBERT E. LATTA, Ohio
DAVID P. ROE, Tennessee
BLAINE LUETKEMEYER, Missouri
GLENN THOMPSON, Pennsylvania
BILL CASSIDY, Louisiana
CYNTHIA M. LUMMIS, Wyoming

Professional Staff

Robert L. Larew, *Chief of Staff*
Andrew W. Baker, *Chief Counsel*
April Slayton, *Communications Director*
Nicole Scott, *Minority Staff Director*

COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, *Vice Chairman*, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS W. CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN H. ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE M. KOSMAS, Florida
ALAN GRAYSON, Florida
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
DANIEL B. MAFFEI, New York

SPENCER BACHUS, Alabama, *Ranking Minority Member*
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
ADAM H. PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. MCCOTTER, Mississippi
KEVIN MCCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER JOHN LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

PROFESSIONAL STAFF

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

CONTENTS

HEARING TO EXAMINE THE REGULATION OF OVER-THE-COUNTER DERIVATIVES

FRIDAY, JULY 10, 2009

HOUSE OF REPRESENTATIVES,
COMMITTEE ON AGRICULTURE,
JOINT WITH
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The Committees met, pursuant to call, at 10:04 a.m., in Room 1100, Longworth House Office Building, Hon. Collin C. Peterson [Chairman of the Committee on Agriculture] presiding.

Members present for Committee on Agriculture: Representatives Peterson, Holden, McIntyre, Boswell, Baca, Scott, Marshall, Cuellar, Costa, Ellsworth, Walz, Kagen, Schrader, Dahlkemper, Pomeroy, Childers, Minnick, Lucas, Goodlatte, Moran, Johnson, Rogers, King, Neugebauer, Conaway, Smith, Latta, Roe, Luetkemeyer, Thompson, Cassidy, and Lummis.

Members present for Committee on Financial Services: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Sherman, Meeks, Moore of Kansas, Capuano, Hinojosa, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Ellison, Wilson, Perlmutter, Donnelly, Foster, Carson, Childers, Minnick, Adler, Kilroy, Kosmas, Himes, Peters, Bachus, Royce, Lucas, Manzullo, Biggert, Hensarling, Garrett, Gerlach, Neugebauer, Putnam, Bachmann, Marchant, McCotter, Posey, Jenkins, Lee, Paulsen, and Lance.

Staff present for Committee on Agriculture: Robert L. Larew, Claiborn Crain, Adam Durand, Scott Kuschmider, Merrick Munday, Clark Ogilvie, James Ryder, April Slayton, Rebekah Solem, Kevin Kramp, Tamara Hinton, Bill O'Conner, and Jamie Mitchell.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Chairman PETERSON. Good morning everybody, and welcome to today's hearing. I want to welcome Treasury Secretary Geithner, and thank him for his time, and I want to thank Financial Services Chairman Frank and his staff for working with me and my staff to have this joint hearing today.

In the interest of time, I will submit my full statement for the record, we have 111 Members of Congress who serve on these two Committees. And I know many of my colleagues who are attending today's hearing have questions for the Secretary.

Last month, the White House presented broad reform proposals to overhaul the financial regulatory system. I am pleased to note that several key provisions regarding over-the-counter derivatives are similar to what the House Agriculture Committee passed this year as part of a bipartisan bill H.R. 977, which would strengthen oversight of futures, options and over-the-counter markets. However, the devil is always in the details and I look forward to hearing additional details today about the Administration's reform ideas. And I hope Secretary Geithner's appearance today will get us into the weeds on how this will work.

[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Good morning, and welcome to today's hearing. I want to welcome, and thank, Treasury Secretary Geithner for his time, and I want to thank Financial Services Chairman Frank and his staff for working with me and my staff to have this joint hearing today.

In the interest of time, I will submit a full statement for the record. We have 111 Members of Congress who serve on these two Committees and I know many of my colleagues who are attending today's hearing have questions for the Secretary.

Last month, the White House presented broad reform proposals to overhaul the financial regulatory system. I am pleased to note that several of their key provisions regarding over-the-counter derivatives are similar to what the House Agriculture Committee passed earlier this year as part of a bipartisan bill, H.R. 977, which would strengthen oversight of futures, options, and over-the-counter markets.

However, the devil is always in the details. I look forward to hearing additional details today about the Administration's reform ideas, and I hope Secretary Geithner's appearance today will help get into the weeds on how this will all work.

I now want to yield 2 minutes of my opening statement time to a Member of both the Agriculture and Financial Services Committee, who has some knowledge about this area, the gentleman from Idaho, Mr. Minnick.

Chairman PETERSON. I now want to yield 2 minutes of my opening statement to a Member of both the Agriculture and Financial Services Committee who has done a lot of work and has some knowledge in this area, the gentleman from Idaho, Mr. Minnick for 2 minutes.

OPENING STATEMENT OF HON. WALT MINNICK, A REPRESENTATIVE IN CONGRESS FROM IDAHO

Mr. MINNICK. Chairman Peterson and Chairman Frank, I am a farm boy who grew up skeptical of Wall Street wondering how a loaf of bread could cost a dollar when it contained only a few cents worth of wheat. I also spent over 20 years as the CEO of substantial companies which relied on Wall Street and used customized derivatives to hedge currency and interest rate risk. I learned that these financial instruments are essential to the proper functioning of our 21st century economy.

I have listened to many experts and studied the Administration's 84 page concept paper. If we are to craft a regulatory structure which can keep our nation from ever again repeating the financial excesses which have brought today's economy to its knees, we need to give serious consideration to the following reforms which go beyond those proposed by the Administration.

First, we should merge the SEC and the Commodity Futures Trading Commission. Financial derivatives whether they originate——

Chairman FRANK. Mr. Minnick, one of the Members on the Republican side just pointed out the acoustics in this room are terrible. Now, when Ways and Means holds forth in this room, this is their room, they consider that an advantage. But we are here not marking up a tax bill but having an important public hearing so we are going to ask everybody to speak fairly loudly, particularly you, Mr. Secretary, because while I can't see you, I would like to be able to hear you. Mr. Minnick may resume.

Mr. MINNICK. First we should merge the SEC and the Commodity Futures Trading Commission. Financial derivatives whether they originate in a commodity, a security, or neither, like weather futures are functionally identical and must be traded, cleared and settled subject to the same rules.

Bifurcated responsibility might be made to work temporarily, but is a poor long-term solution which will discourage bold action when crises arise and will encourage regulatory arbitrage.

Second, banking regulation should be removed from an already overburdened Federal Reserve and the remaining three Federal depository institution regulators, the OTS, the FDIC and the OCC should be combined into a single Federal bank regulator; which should also be given broad consumer protection responsibility and resolution authority for both banks and all other entities deemed systemically risky.

Powerful global institutions like Citibank, Bank of America, or AIG should not be allowing to shop for the weakest Federal regulator. Finally, the proposed systemic risk oversight counsel should have the highest quality permanent staff if it is to respond appropriately as future dangers arise. Because the Federal Reserve is the more institutionally independent Executive Branch agency, and has increasing global responsibilities, that staff should be housed in the Fed and the counsel should be chaired by the Fed Chairman. I thank both chairs and yield back.

Chairman PETERSON. I thank the gentleman and just for clarification, the gentleman spent a lot of time looking at this, but Mr. Frank and I, at least the two of us, have come to the conclusion that we are not going to be merging the SEC and CFTC, but we appreciate the gentleman's comments.

Now, I want to recognize the Chairman of the Financial Services Committee, Mr. Frank. He and I have gotten together and we have a good working relationship, and we think we are close to having a consensus on where to move with this. You can see by this hearing today that we have a good cooperation going on between the two Committees. Mr. Frank. Oh, excuse me, I am sorry, I screwed up. I am supposed to recognize Mr. Lucas, I am getting ahead of myself. I didn't mean to overlook you, Mr. Lucas, my good friend from Oklahoma, who worked with us to get H.R. 977 out of the Agriculture Committee last February. Mr. Lucas is recognized. And by the way, we are going to limit people to 4 minutes because of all of the Members that are involved, so we would hope that everybody would abide by that.

Mr. Geithner, we are not going to hold you to 4 minutes, we want to hear what you have to say. Mr. Lucas.

OPENING STATEMENT OF HON. FRANK D. LUCAS, A REPRESENTATIVE IN CONGRESS FROM OKLAHOMA

Mr. LUCAS. Thank you, Mr. Chairman and thank you to both Chairmen for holding this joint hearing to hear the Treasury's proposal to regulate over-the-counter derivatives, as well as examine the legislation that the House Agriculture Committee passed a few months ago. I, as Ranking Member of the House Agriculture Committee and senior Member of the Financial Services Committee, I would like for this occasion to examine the issue from two different perspectives. The Agriculture Committee has been very active in exploring the role derivatives play in the marketplace, and in the overall economy.

The Committee has held numerous hearings to gain further information and insight into the complex nature of credit default swaps and how they should be regulated. In February of this year, as the Chairman noted, the Agriculture Committee passed H.R. 977, the Derivatives Markets Transparency and Accountability Act.

No one can argue that the concepts of transparency and accountability are wrong, but we must make certain that our actions call for an appropriate level of regulation that will respect the nature of the marketplace and encourage product innovation and economic growth. Derivatives do serve a valid purpose in the marketplace when used with judgment. They are essential for managing risk. We must consider that there are numerous industries that have legitimate price risk and there must be a way to mitigate that. Derivatives provide a legitimate means for managing that risk. The financial problems that we have seen recently are not the result of merely the existence of derivatives, but rather because there are problems in measuring their true performance, or knowing with certainty the depth and breadth of the over-the-counter market, or knowing with confidence the creditworthiness of the counterparty.

Simply put, the marketplace can be protected from market failures if regulators are fully aware of the threat. Ignorance of this relatively new financial instrument caused much of the financial failures. We now know that these complex markets need better models and methods for oversight and transparency. However, we must be careful not to overreach and force businesses into very expensive clearing operations that cost capital that they do not have, or force them out of risk mitigation all together. Business will then be forced to manage risk with higher prices, which will ultimately be passed on to consumers. The need to avoid artificial costs for business was the reason I opposed the clearing requirement in H.R. 977. There is considerable concern that section 13, as currently drafted, which relates to the clearing requirement will stifle invasion in the over-the-counter market.

CFTC needs more authority to waive the clearing requirements in section 13 so new and safer products can get to the market in a timely fashion. This would recognize the fact that not all contracts can be cleared and that there is a need for customized contracts. These are just a few of the concerns I have on my part as we move forward today.

Again, I thank you for the opportunity to discuss the issues regarding these important financial institutions. And Secretary

Geithner, I look forward to your testimony and the answers to the questions posed by the panel. Thank you, Chairman.

Chairman PETERSON. I thank the gentleman, and now I am pleased to recognize my good friend the Chairman of the Financial Services Committee, Mr. Frank.

OPENING STATEMENT OF HON. BARNEY FRANK, A REPRESENTATIVE IN CONGRESS FROM MASSACHUSETTS

Chairman FRANK. Thank you, Mr. Peterson and I begin with an apology to our friends in the media, there is no fight to cover between these two Committees. I know that that is an easier topic than the complexities of how to actually do something. But I believe that the besetting sin of the House of Representatives is jurisdictional fights, in which our egos get in the way of good public policy. I am very proud that Chairman Peterson and I and other Members of our Committee, as well as Chairman Gensler and Chairwoman Shapiro have made very extra special efforts to avoid that. And I believe we have achieved that. And there will be some disagreements, but they will be based on substance.

There are some areas where there are no disagreements. Clearly we will be significantly expanding the regulation of derivatives. And I want to address the issue that was raised by the very thoughtful gentleman from Idaho, with whom I agree on most issues, but not on the question of the merger. I will say that if we were starting from scratch, I don't think we would have the current organizational structure. But we are not starting from scratch, and I don't think it is practical to talk about making those major changes. But I will also say this, there have been some complaints that what the Obama Administration has proposed, and they have a great deal of credit coming to them for the initiatives they are taking, the a broad range of financial restructuring, and some of what we are talking about. Some people have complained there is not enough structural change.

Frankly, I think that is the wrong issue. What we should be held accountable for is making substantive changes in the rules. Who does these things is less important to me than what is done. And by the time we are through in the collaboration between these two Committees, in the work of the Congress as a whole, and in the work that the Financial Services Committee will do, we will, I believe, have substantially increased the authority of regulators to deal with these things. We have within our jurisdiction the question of hedge funds. I believe that hedge funds should be required to register. We will be talking about further expansion derivatives and undoing some of the decisions not to deal with them in the past. We will be talking about a number of other areas where we will be making some important substantive changes and giving the regulators the authority to do things.

With regard to derivatives, clearly the gentleman from Oklahoma is correct, they play an important role. The problem we have is this: the role of the financial sector is to be an intermediary between people who are engaged in the productive activity of the economy, and people who have the money that they need to do that. The role of the intermediaries is to gather up money in reasonably small amounts from large numbers of people and have them available to those people who will do productive activity.

I believe that one of the problems that we have seen in the past couple of decades is that there has become a confusion between ends and means, that is activity that is a very important means to the end of productive activity has become for some in our society an end in itself. Our job is to try and separate those things out. Where we have instruments, activities, entities that are an important means to gathering the funds that our private sector economy needs to do productive activity, we need to protect that.

We need to make sure it is done with integrity, we need to give encouragement to investors who may be afraid to invest, that is why I regard sensible regulations of the market as very pro-market. You protect the people with integrity from those who might try to cut corners. You give some encouragement to those who should be investing.

Our job is to reduce the extent to which there are things that go on for their own sake. I believe we are capable of doing that, and I am very pleased, Chairman Peterson and I, and our Committees are well on the way in cooperation with the Administration to adopting such rules.

And I now recognize the Ranking Member of the Financial Services Committee, the gentleman from Alabama, Mr. Bachus.

OPENING STATEMENT OF HON. SPENCER BACHUS, A REPRESENTATIVE IN CONGRESS FROM ALABAMA

Mr. BACHUS. Thank you, Mr. Chairman. As the Chairman and the Ranking Member of the Agricultural Committee have said, derivatives serve an important function in the market, they allow—they allow thousands of companies—I am going to start over.

Thank you. Does that work? All right.

As the three gentlemen before me said, derivatives serve an important function in the market. They allow companies to hedge against risk, to deploy capital more effectively, to lower their costs and to offer protection against fluctuating prices. Derivatives are about shifting risk, and my greatest concern is that we do not want a system, and I fear that the Administration is going down the path of shifting that risk, not to the investors or to the dealers, but ultimately to the taxpayers. The companies, the four companies that will deal in these derivatives—over-the-counter derivatives—the most will be four or five of the largest companies, financial companies in America. All of them will be deemed to be systemically significant.

Part of the Administration's proposal is for when these companies get in trouble, and one reason they could get in trouble is trading in these over-the-counter derivatives, because they can protect against risk, they can lower costs. But as we saw with, I guess, Enron as a great example, they can take both dealers and investors down. And when that happens I would like some assurance that the taxpayers are not going to ultimately be the ones who assume that risk, that is not what we ought to be about.

Now, leading up to last September, a lot of people made investments, they wrote over-the-counter derivatives, they made billions of dollars, profits on the way up, but when things turned down who was asked to come in and backstop them? Who was asked to take the risk, to suffer the loss? It was the taxpayer.

Now I personally believe that we ought to allow corporations to continue to write customized derivatives and that yes, the government can look at them. But another thing that we ought to consider is whether the government is the best party to judge risk? And I say, no. I think the government has a very poor track record of regulators in identifying risk. Are we going to leave—when we start having standardized trading of over-the-counter derivatives, particularly the more complex ones and the regulators bless those trades, or say that they are safe, are we going to attract a whole new generation of investors who think that they are investing in a safe security or future.

We found out with Fannie and Freddie that people began to think it was an implied government guarantee and they invested in those stocks. We need to totally avoid any implication that just because the government is going to regulate these markets they are going to insure these markets or backstop these markets. And I would like some assurance from the Secretary of the Treasury that however we ultimately decide the level of regulation—I look forward to the Memorandum of Understanding between the Fed, the CFTC and the SEC—that ultimately the taxpayers do not come in and take the burden, the risk, and the cost of over-the-counter derivatives gone bad. Thank you, Mr. Secretary.

Chairman PETERSON. I thank the gentleman and I thank the Members for their attendance and the Chairman, and the Ranking Members for their statements. The Chairman requests that other Members submit their opening statements for the record.

[The prepared statement of Mrs. Bachmann follows:]

PREPARED STATEMENT OF HON. MICHELE BACHMANN, A REPRESENTATIVE IN CONGRESS FROM MINNESOTA

Thank you, Mr. Chairman. And, what a pleasure it is to have a fellow Minnesotan co-chairing this hearing today. Thank you, Mr. Peterson, as well.

And, thank you, Secretary Geithner, for being here today and I look forward to the discussion.

Many U.S. companies responsibly utilize over-the-counter derivatives on a daily basis to manage their risks and limit damage to their balance sheets. These end-users are America's job-creators and Congress should be careful not to over-reach and infringe on their ability to hedge risks responsibly.

Our Subcommittee on Capitol Markets held a helpful hearing on this issue in June. Chairman Kanjorski invited end-users such as 3M, a global company headquartered in Minnesota, to testify so that we could hear their perspective on this important issue. We heard the sincere concern of end-users and manufacturers about losing their ability to use customized over-the-counter derivatives to hedge against foreign exchange, interest rate, and commodity price risks.

I agree with Chairman Kanjorski's sentiment from that hearing that we should try to find the right balance as we move forward on this issue. While we want to improve oversight and transparency of the derivatives market, as Chairman Kanjorski stated, "subjecting all contracts to mandatory exchange trading may cast too wide a net." (*Financial Times,* 6/10/09)

The proposal submitted by the President, the legislation reported out of the Agriculture Committee in February (H.R. 977), and the Waxman-Markey cap-and-tax bill (H.R. 2454) all cast very wide nets and do not seem to make any attempt to differentiate between varying types of derivatives products. They ignore the concerns we've heard from American businesses about why mandatory clearing for all these financial products could hamper their ability to properly hedge risks.

Particularly in the current economic climate, I question the prudence of impairing their ability to manage genuine operating risks. The end result would likely be unnecessarily sidelining precious capital—capital that we need in the marketplace to create jobs and help the economy recover.

We should be looking for ways to improve our current patchwork of financial regulation and move toward a more effective and efficient system that legitimately improves safety and soundness.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Chairman PETERSON. Mr. Secretary, we appreciate you being with us. We look forward to your statement, and Members I guess we have votes coming up at 10:30, but we will have time for the Secretary's statement and maybe a couple of questions. So Mr. Secretary.

STATEMENT OF HON. TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Secretary GEITHNER. Thank you, Chairman Peterson, Chairman Frank, and Ranking Members Lucas and Bachus. I am grateful for the chance to come before you today. I want to compliment both of you and your colleagues for already doing so much thoughtful work in trying to lay the foundation for reform, and for bringing this basic spirit of pragmatic cooperation, transcending the classic institutional differences that have made it harder to make progress in these areas in the past.

Before I get to the subject of this hearing, which is the important need to bring comprehensive oversight and regulation to the derivative markets, I just want to make a few broader points about the imperative of comprehensive reform. There are some who have suggested that we are trying to do too much too soon, that we should wait for a more opportune moment when the crisis has definitively receded. There are some who are beginning to suggest that we don't need comprehensive change, even though the cost of this crisis has been brutally damaging to millions of Americans to hundreds of thousands of businesses, to economies around the world, and to confidence in our financial system.

And there are some who argue that by making regulations smarter and stronger will destroy innovation. And there are even some who argue that we should leave responsibility for consumer protection for mortgages and consumer credit products, largely, where it is today.

Now, in my view, these voices are essentially arguing that we maintain the *status quo*, and that is not something we can accept. Now, it is not surprising that we are having this debate, it is the typical pattern of the past. As the crisis starts to recede, the impetus to reform tends to fade in the face of the complexity of the task, and with opposition by the economic and institutional interests that are affected. It is not surprising because the reforms proposed by the President, and the reforms that your two Committees are discussing, would: substantially alter the ability of financial institutions to choose their regulator; shape the content of future regulation; and to continue the financial practices that were lucrative for parts of the industry for a time, but did ultimately prove so damaging. But this is why we have to act and why we need to deliver very substantial change.

Any regulatory reform of this magnitude requires deciding how to strike the right balance between financial innovation and efficiency on the one hand, and stability and protection on the other.

And we failed to get this balance right in the past. And if we do not achieve sufficient reform, we will leave ourselves weaker as a nation, weaker as an economy and more vulnerable to future crises.

Now one of the most significant developments in our system during recent decades has been the very substantial growth and innovation in the market for derivatives, in particular the over-the-counter derivative market. Because of this enormous scale and the critical role these instruments play in our markets, establishing a comprehensive framework of oversight for derivatives is crucial.

Although derivatives bring very important benefits to our economy by enabling companies to manage risk, they also pose very substantial challenges. Under our existing regulatory system, some types of financial institutions were allowed to sell very large amounts of protection against certain risks without adequate capital to back those commitments. The most conspicuous and the most damaging examples of this were the monoline insurance companies and AIG. Banks were able to reduce the amount of capital they held against risk by purchasing credit protection from thinly capitalized, special purpose insurers subject to little or no initial margin requirements.

The complexity of the instruments overwhelm the checks and balances risk management and supervision, weaknesses that were magnified by very systematic failures in judgment by the credit rating agencies. These failures enabled a substantial increase in leverage both outside and within the banking system. Inadequate enforcement authority and information made the system more vulnerable to fraud and to market manipulation, and because of a lack of transparency in the OTC derivative markets the government and market participants did not have enough information about the location of risk exposures, or the extent of mutual interconnection among firms. And this lack of visibility, magnified contagion as the crisis intensified, causing a very damaging wave of deleveraging, and margin increases, the classic margin spiral, contributing to a general breakdown in credit markets.

Now these problems in derivatives were not the sole or the principal cause of the crisis, but they made the crisis more damaging and they need to be addressed as part of the comprehensive reform. Our proposals for reform are designed to protect the stability of our financial system, to prevent market manipulation, fraud and other abuses, to provide greater transparency, and protect consumers and investors by restricting inappropriate marketing of these products to unsophisticated parties.

This proposed plan will provide strong regulation and transparency for all OTC derivative products, both standardized and customized, and strong supervision and regulation for all OTC derivative dealers and other major market participants in these markets. And we propose to achieve these goals with the following broad steps. First, we propose to require that all standardized derivatives contracts be cleared through, well-regulated central counterparties and executed either on regulated exchanges or regulated electronic trade execution systems. Central clearing makes possible the substitution of a regulated clearinghouse between the original counterparties to a transaction. And with central clearing, the original counterparties no longer have credit exposure to each other. They place that credit exposure to a clearinghouse, backed by financial safeguards that are established through regulation.

Second, we propose to encourage substantially greater use of standardized OTC derivatives, and thereby to facilitate a more substantial migration of these OTC derivatives onto central clearinghouses and exchanges. We will also require, and I want to underscore this, that regulators police any attempts by market participants to use spurious customization to avoid central clearing and exchanges. And in this context, we will impose higher capital and margin requirements for counterparties using customized and non centrally cleared derivative products to account for higher level of risk.

Third, we propose to require that all OTC derivative dealers and all major market participants be subject to substantial supervision and regulation, including appropriately conservative capital margin requirements, and strong business conduct standards, to better ensure that dealers have the capital needed to make good on the protection they provide.

Fourth, we propose steps to make OTC derivative markets fully transparent. Relevant regulators will have access, on a confidential basis, to all transactions and open positions of individual market participants. The public will have access to aggregated data on opening positions and trading volumes. To bring about this high level of transparency we require the SEC and CFTC to impose record-keeping and reporting requirements, including an audit trail on all OTC derivatives and trades, and to provide information on all OTC derivative trades to a regulated trade repository.

Fifth, we propose to provide the SEC and the CFTC with clear unimpeded authority to take regulatory and civil action against fraud, market manipulation and other abuses in these markets. And we will work with the SEC and the CFTC to tighten the standards to govern who can participate in these markets.

And finally we will continue to work closely with our international counterparts to help ensure that our regulatory regime is matched by similarly affected efforts in other countries, these are global markets and for these standards to be effective they have to be applied and enforced on a global basis. Now with these reforms we will bring protection that exists in other financial markets, protections that exists to prevent fraud and manipulation in other markets, and preserve market integrity of the OTC derivative markets. The SEC and CFTC will have full enforcement authority. Firms will no longer be able to use derivatives to make commitments with inadequate capital.

No dealer in these markets will escape oversight, and we will bring the risk reducing and financial stability promoting benefits of central clearing to these important markets.

Now turning these proposals into law will require complex, difficult judgments. And some of these judgments will involve assigning jurisdiction over particular transactions and particular participants to our regulatory agencies. I want to say we have been working closely as you have with the SEC and CFTC over the last few months to develop a sensible, pragmatic allocation of duties and have made very, very substantial progress in narrowing the issues. And I want to join the Chairman in complimenting Chairman

Schapiro and Chairman Gensler for working so closely and productively together.

As Congress moves to craft legislation, we are moving quickly, along with other relevant agencies, to advance the overall process of reform. Just as an example, we provided detailed legislative language for the establishment of the Consumer Financial Protection Agency to Congress just last week. The SEC is moving forward with new rules to govern and reform credit rating agencies. And the CFTC as you saw, announced hearings recently on whether to impose limits on speculation in energy derivatives in order to dampen price swings, and to require new disclosure by derivative traders. Those are just some examples of things we are doing as you move forward to consider legislation.

Now we welcome the commitment of these Committees, and of the Congressional leadership, to move forward in legislation this year. This is an enormously complicated project and it is important we get it right. We share responsibility for fixing the system, and we can only do that with comprehensive reform. I look forward to answering your questions and talking through the range of important complex issues we face in the reform effort. Thank you, Mr. Chairman.

[The prepared statement of Secretary Geithner follows:]

PREPARED STATEMENT OF HON. TIMOTHY F. GEITHNER, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Chairman Frank, Ranking Member Bachus, Chairman Peterson, Ranking Member Lucas, Members of the Financial Services and Agriculture Committees, thank you for the opportunity to testify today about a key element of our financial regulatory reform package—a comprehensive regulatory framework for the over-the-counter (OTC) derivatives markets.

Over the past 2 years, we have faced the most severe financial crisis in generations. Some of our largest financial institutions failed. Many of the securities markets that are critical to the flow of credit in our financial system broke down. Banks came under extraordinary pressure. And these forces magnified the overall downturn in the housing market and the broader economy.

President Obama, working with the Congress, has taken extraordinary steps to stabilize the economy and to repair the damage to the financial system. As we continue to put in place conditions for economic recovery, we need to lay the foundation for a safer, more stable financial system in the future.

This financial crisis has exposed a set of core problems with our financial system. The system permitted an excessive build-up of leverage, both outside the banking system and within the banking system.

The shock absorbers that are critical to preserving the stability of the financial system—capital, margin, and liquidity cushions in particular—were inadequate to withstand the force of the global recession, and they left the system too weak to withstand the failure of major financial institutions.

In addition, millions of Americans were left without adequate protection against financial predation, particularly in the mortgage and consumer finance areas. Many were unable to evaluate the risks associated with borrowing to support the purchase of a home or to sustain a higher level of consumption.

The United States entered this crisis without an adequate set of tools to contain the risk of broader damage to the economy and to manage the failure of large, complex financial institutions.

Many forces contributed to these problems. Household debt rose dramatically as a share of total income, financed by a willing supply of savings from around the world. Risk management practices at financial firms failed to keep abreast of the rising complexity of financial instruments. Compensation rose to exceptionally high levels in the financial sector, with rewards for executives unmoored from an assessment of long-term risk for the firm, thus mis-aligning the incentive structures in the system. Our framework of financial supervision and regulation, designed in a different era for a more simple bank-centered financial system, failed in its most basic responsibility to produce a stable and resilient system for providing credit and protecting consumers and investors.

The Administration proposed in June a comprehensive set of reforms to address the problems in our financial system that were at the core of this crisis and to reduce the risk of future crises.

We proposed to establish a new Consumer Financial Protection Agency with the power to establish and enforce protections for consumers on a wide array of financial products.

We proposed to put in place more conservative constraints on risk taking and leverage through higher capital requirements for financial institutions and stronger cushions in the core market infrastructure.

We proposed to extend the scope of regulation beyond the traditional banking sector to cover all firms who play a critical role in market functioning and the stability of the financial system.

We proposed to put in place stronger tools for managing the failure of large, complex financial institutions by adapting the resolution process that now exists for banks and thrifts.

We proposed to reduce the substantial opportunities for regulatory arbitrage that our system permitted by consolidating safety and soundness supervision for Federal depository institutions, eliminating loopholes in the Bank Holding Company Act, moving toward convergence of the regulatory frameworks that apply to securities and futures markets, and establishing more uniform standards and enforcement of standards for financial products and activities across the system.

And we proposed to work with other countries to establish strong international standards, so the reforms we put in place here are matched and informed by similarly effective reforms elsewhere.

Any regulatory reform of magnitude requires deciding how to strike the right balance between financial innovation and efficiency, on the one hand, and stability and protection, on the other. We failed to get this balance right in the past. The reforms that we propose seek to shift the balance by creating a more resilient financial system that is less prone to periodic crises and credit and asset price bubbles, and better able to manage the risks that are inherent in innovation in a market-oriented financial system.

We consulted widely with Members of Congress, consumer advocates, academic experts, and former regulators in shaping our recommendations. And we look forward to refining these recommendations through the legislative process.

One of the most significant developments in our financial system during recent decades has been the substantial growth and innovation in the markets for derivatives, especially OTC derivatives.

Because of their enormous scale and the critical role they play in our financial markets, establishing a comprehensive framework of oversight for the OTC derivative markets is crucial to laying the foundation for a safer, more stable financial system.

A derivative is a financial instrument whose value is based on the value of an underlying "reference" asset. The reference asset could be a Treasury bond or a stock, a foreign currency or a commodity such as oil or copper or corn, a corporate loan or a mortgage-backed security. Derivatives are traded on regulated exchanges, and they are traded off-exchanges or over-the-counter.

The OTC derivative markets grew explosively in the decade leading up to the financial crisis, with the notional amount or face value of the outstanding transactions rising more than six-fold to almost $700 trillion at the market peak in 2008. Over this same period, the gross market value of OTC derivatives rose to more than $20 trillion.

Although derivatives bring substantial benefits to our economy by enabling companies to manage risks, they also pose very substantial challenges and risks.

Under our existing regulatory system, some types of financial institutions were allowed to sell large amounts of protection against certain risks without adequate capital to back those commitments. The most conspicuous and most damaging examples of this were the monoline insurance companies and AIG. These firms and others sold huge amounts of credit protection on mortgage-backed securities and other more complex real-estate related securities without the capacity to meet their obligations in an economic downturn.

Banks were able to get substantial regulatory capital relief from buying credit protection on mortgage-backed securities and other asset-backed securities from thinly capitalized, special purpose insurers subject to little or no initial margin requirements.

The apparent ease with which derivatives permitted risk to be transferred and managed during a period of global expansion and ample liquidity led financial institutions and investors to take on larger amounts of risk than was prudent.

The complexity of the instruments that emerged overwhelmed the checks and balances of risk management and supervision, weaknesses that were magnified by systematic failures in judgment by credit rating agencies. These failures enabled a substantial increase in leverage, outside and within the banking system.

Because of a lack of transparency in the OTC derivatives and related markets, the government and market participants did not have enough information about the location of risk exposures in the system or the extent of the mutual interconnections among large firms. So, when the crisis began, regulators, financial firms, and investors had an insufficient basis for judging the degree to which trouble at one firm spelled trouble for another. This lack of visibility magnified contagion as the crisis intensified, causing a very damaging wave of deleveraging and margin increases, and contributing to a general breakdown in credit markets.

Market participants and investors used derivatives to evade regulation, or to exploit gaps and differences in regulation, and to minimize the tax consequences of investment strategies.

The lack of transparency in the OTC derivative markets combined with insufficient regulatory policing powers in those markets left our financial system more vulnerable to fraud and potentially to market manipulation.

These problems were not the sole or the principal cause of the crisis, but they contributed to the crisis in important ways. They need to be addressed as part of comprehensive reform. And they cannot be adequately addressed within the present legislative or regulatory framework.

In designing its proposed reforms for the OTC derivative markets, the Administration has attempted to achieve four broad objectives:

- Preventing activities in the OTC derivative markets from posing risk to the stability of the financial system;
- Promoting efficiency and transparency of the OTC derivative markets;
- Preventing market manipulation, fraud, and other abuses; and
- Protecting consumers and investors by ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties.

Our proposals have been carefully designed to provide a comprehensive approach. The plan will provide for strong regulation and transparency for *all* OTC derivatives, regardless of the reference asset, and regardless of whether the derivative is customized or standardized. In addition, our plan will provide for strong supervision and regulation of *all* OTC derivative dealers and *all* other major participants in the OTC derivative markets.

We propose to achieve this with the following broad steps:

First, we propose to require that *all* standardized derivative contracts be cleared through well-regulated central counterparties and executed either on regulated exchanges or regulated electronic trade execution systems.

Central clearing involves the substitution of a regulated clearinghouse between the original counterparties to a transaction. After central clearing, the original counterparties no longer have credit exposure to each other—instead they have credit exposure to the clearinghouse only. Central clearing of standardized OTC derivatives will reduce risks to those on both sides of a derivative contract and make the market more stable. With careful supervision and regulation of the margin and other risk management practices of central counterparties, central clearing of a substantial proportion of OTC derivatives should help to reduce risks arising from the web of bilateral interconnections among our major financial institutions. This should help to constrain threats to financial stability.

Second, through capital requirements and other measures, we propose to encourage substantially greater use of standardized OTC derivatives and thereby to facilitate substantial migration of OTC derivatives onto central clearinghouses and exchanges.

We will propose a broad definition of "standardized" OTC derivatives that will be capable of evolving with the markets and will be designed to be difficult to evade. We will employ a presumption that a derivative contract that is accepted for clearing by any central counterparty is standardized. Further attributes of a standardized contract will include a high volume of transactions in the contract and the absence of economically important differences between the terms of the contract and the terms of other contracts that are centrally cleared.

We also will require that regulators carefully police any attempts by market participants to use spurious customization to avoid central clearing and exchanges. In addition, we will raise capital and margin requirements for counterparties to all customized and non-centrally cleared OTC derivatives. Given their higher levels of risk, capital requirements for derivative contracts that are not centrally cleared must be set substantially above those for contracts that are centrally cleared.

Third, we propose to require *all* OTC derivative dealers, and *all* other major OTC derivative market participants, to be subject to substantial supervision and regulation, including conservative capital requirements; conservative margin requirements; and strong business conduct standards. Conservative capital and margin requirements for OTC derivatives will help ensure that dealers and other major market participants have the capital needed to make good on the protection they have sold.

Fourth, we propose steps to make the OTC derivative markets *fully* transparent. Relevant regulators will have access on a confidential basis to the transactions and open positions of individual market participants. The public will have access to aggregated data on open positions and trading volumes.

To bring about this high level of transparency, we will require the SEC and CFTC to impose record-keeping and reporting requirements (including an audit trail) on all OTC derivatives. We will require that OTC derivatives that are not centrally cleared be reported to a regulated trade repository on a timely basis.

These reforms will bring OTC derivative trading into the open so that regulators and market participants have clear visibility into the market and a greater ability to assess risks in the market. Increased transparency will improve market discipline and regulatory discipline, and will make the OTC derivative markets more stable.

Fifth, we propose to provide the SEC and CFTC with clear authority for civil enforcement and regulation of fraud, market manipulation, and other abuses in the OTC derivative markets.

Sixth, we will work with the SEC and CFTC to tighten the standards that govern who can participate in the OTC derivative markets. We must zealously guard against the use of inappropriate marketing practices to sell derivatives to unsophisticated individuals, companies, and other parties.

Finally, we will continue to work with our international counterparts to help ensure that our strict and comprehensive regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries.

Turning our proposals into law will require that a number of difficult judgments be made. Some of these judgments involve assigning jurisdiction over particular transactions or particular market participants to particular regulatory agencies. We have been working with the SEC and the CFTC over the past few months to develop a sensible allocation of duties. We have made great progress in narrowing the outstanding issues, and intend to send up draft legislation that will provide for a clear allocation of oversight authority between the SEC and CFTC. In making these decisions, we are striving to utilize each agency's expertise, eliminate gaps in regulation, eliminate uncertainty about which agency regulates which types of derivatives, and maximize consistency of the regulatory approach of the two agencies.

Our plan will help prevent the OTC derivative markets from threatening the stability of the overall financial system.

By requiring central clearing of all standardized derivatives and by requiring all OTC derivative dealers and all other significant OTC market participants to be strictly supervised by the Federal Government, to maintain substantial capital buffers to back up their obligations, and to comply with prudent initial margin requirements, the regulatory framework that we seek to put in place should help lower systemic risk.

Our plan will help make the derivatives markets more efficient and transparent.

By requiring all standardized derivatives to be cleared through regulated central counterparties and executed on regulated exchanges or through regulated electronic trade execution systems and by requiring that detailed information about all types of derivatives be readily available to regulators, our plan will help ensure that the government is not caught—as it was in this crisis—with insufficient visibility into market activity, risk concentrations, and connections between firms.

Our plan will help prevent market manipulation, fraud and other abuses by providing full information to regulators about activity in the OTC derivative markets and by providing the SEC and the CFTC with full authority to police the markets.

Finally, our plan will help protect investors by taking steps to prevent OTC derivatives from being marketed inappropriately to unsophisticated parties.

As Congress moves to craft legislation to reform our financial system, we are moving quickly to advance the overall process.

Following the release of our White Paper on financial regulatory reform in mid-June, we sent up detailed legislative language for the establishment of the Consumer Financial Protection Agency.

We have used the President's Working Group on Financial Markets to pull together all government agencies that oversee elements of the financial system to begin the process of formulating more detailed proposals for implementing the comprehensive reforms outlined by the President.

The SEC is moving forward to put in place new rules to govern credit-rating agencies, which failed to adequately assess the risks of mortgage-backed and other structured securities at the center of the crisis.

The CFTC has announced hearings on whether to impose limits on speculation in energy derivatives in order to dampen price swings, and to require new disclosures by derivative traders.

SEC Chairman Schapiro and CFTC Chairman Gensler were recently on Capitol Hill testifying together about progress in coordinating their agencies' approaches to derivatives and developing a reasonable division of labor in the oversight of these markets.

We welcome the commitment of the Congressional leadership and of the key Committees to move forward with legislation this year. This is an enormously complex project. It is important that we get it right. And we need a comprehensive approach.

This crisis caused enormous damage to trust and confidence in the U.S. financial system and to the American economy.

We share responsibility for fixing the system and we can only do that with comprehensive reform.

We look forward to working with you to achieve that objective.

Chairman PETERSON. Thank you, Mr. Secretary.

We have 8 or 9 minutes before votes, so I will go ahead with a couple of questions here.

First of all—in our bill—we propose mandatory clearing, and if they can not be cleared, then we give CFTC the requirement that they put some margin and collateral requirements on the transaction. One of the questions that I still have, apparently you are not ready to give us a detailed response on how this is going to work, but, it mentions a broad definition of *standardized*, the presumption of standardized and cleared and that high volume will be an attribute of a standardized contract, which for me kind of just raises even more questions about what is going on here.

So while you may not be able to give us a detail of what a standardized OTC derivative is today, can you tell us to what degree of certainty will a swap dealer or end-user of derivatives be able to know going into a swap whether it is going to be classified as standardized or customized, will the answer be in the statute itself or a regulation promulgated by Federal regulators? Will clearinghouses be providing answers based on if they choose to clear the derivative or not, or will the market, as a whole, show the way based on volume of the OTC derivative? And how much confidence will market participants have beforehand whether the OTC derivative they enter into will be judged standardized or customized?

Secretary GEITHNER. Mr. Chairman, of course we want to have—we want to give people as much clarity as we can *ex ante.* I don't think we made a final judgment yet about to what extent we wanted to find those attributes and standardize them in statute or in regulation. I think my suspicion of what we will recommend is that we will lay out broad principals in statute, and have them defined with more clarity in regulation.

I think the important thing is that, again, that we move the standardized derivatives onto central clearing, but we establish comprehensive enforcement authority, comprehensive transparency, comprehensive reporting, sufficiently conservative margin and capital requirements across the entire market. And to avoid the risk that our definition of *standardized* is arbitraged, that people try to get around that definition and design customized products to escape the protections that come with that, we are going to propose to put higher capital requirements on the customized products to limit that risk.

Again, the basic design of this proposal is to make sure there is comprehensive oversight over all transactions in these markets, and comprehensive authority to the SEC and CFTC to police and deter fraud and manipulation in those markets, and to make sure there are appropriately conservative capital margin requirements across those instruments.

Chairman PETERSON. Thank you. Thank you. What about if the clearinghouse determines there is too much risk, too little profit in clearing some standardized OTC transaction? Or what happens it no central counterparty will clear a standardized contract, or do you think the central counterparties should be required to take on this business?

Secretary GEITHNER. Having thought through that, I don't think that is likely to be a significant risk, because, I think the economic instruments of the participants will encourage central clearing. As the markets become more standardized, it is more economically efficient for a greater share of those products to move to central clearing. Both sides of the parties will be, particularly the users of the markets, will have an interest in seeing that, but that is something we will think through carefully with you.

Chairman PETERSON. Well, thank you very much. I think we are going to recess the Committee and go over and vote. I don't know how many there are, but we will come back promptly after the votes. Secretary, we appreciate your patience being with us. We will stand in recess.

[Recess.]

Chairman FRANK. The next Member of the panel to question is the senior Republican on the Agriculture Committee, the gentleman from Oklahoma, Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman.

And I would ask, by unanimous consent, a letter from Chesapeake that was copied to me and, I believe, the Secretary to be entered into the record, if that is possible, sir.

Chairman PETERSON. Without objection.

[The document referred to is located on p. 59.]

Mr. LUCAS. Thank you, Mr. Chairman.

Mr. Secretary, OTC contracts are used to manage, of course, very real risks. And the OTC market's very purpose is to provide customized solutions that meet the individual needs of customers. Denying or effectively limiting access to these risk tools by eliminating, in effect, OTC contracts, which mandated clearing essentially does, jeopardizes the ability to hedge market risk, exposing customers to increasing price volatility.

Why isn't reporting of OTC trades enough, sir?

Secretary GEITHNER. If we were to mandate clearing, central clearing of all derivative products, we would, in effect, be banning customized products. We are not proposing to do that, in part because we believe that there are a broad range of risks that cannot be adequately hedged and managed without recourse to more specialized, tailored instruments.

We also believe, however, that we need to have, as I said earlier, a comprehensive framework of reporting, enforcement authority, and capital requirement protections across all those instruments. But for the reasons you said, and many people have pointed out, to force clearing of all derivatives would ban customized. We do not believe that is necessary, even though we think it is very important to have a comprehensive framework of protections around all those products.

Mr. LUCAS. So, then it is fair to say, Secretary, that you would agree that if the regulator knows about the trades, if the regulator has the necessary tools, that that should be sufficient to address and to avoid potential systematic risk?

Secretary GEITHNER. I believe that for the customized part of the market——

Mr. LUCAS. Customized part, of course.

Secretary GEITHNER.—you want to make sure that there is adequate capital and margin held against those exposures. That the SEC and the CFTC, the relevant authorities in this case, have the full protections to police those markets to prevent manipulation and fraud. And that requires a level of reporting and transparency that we do not have today.

Mr. LUCAS. And you indicated in your opening comments, Secretary, that for these kind of contracts, potentially, the capital requirements could be substantially higher than for the standardized contracts, the things that would be traded by an exchange.

Could you give us a feel for, in your mind, how much more the standards would be for these kind of products?

Secretary GEITHNER. I can't tell you how much higher, but let me just explain the rationale for that.

The first is, of course, that these customized products can often entail more leverage, more uncertainty about future risk, less capacity to judge future risk. And that, in and of itself, requires a higher level of capital, to compensate for that level of risk.

The second is, of course, we want to avoid creating a situation where people are encouraged to use customized when there is a standardized option that is economically compelling.

Mr. LUCAS. But you would agree that there are a number of industries, whether it is ag or energy, or a variety of industries, where the circumstances are so unique that there has to be an option for these customized contracts?

Secretary GEITHNER. I do believe that. And I have a stack of letters here in my book from companies across the country in the power business, in the commodities business, in the business of producing large-scale machinery, that speak to the importance of maintaining that option.

But I want to underscore that, because those products come with a lot of risk—and a lot of the losses that were so conspicuous in the monoline insurance companies and AIG were from institutions writing protections against the customized products. And, therefore, it is important that there be, as I said, a comprehensive framework of oversight and authority over those instruments, as well.

Mr. LUCAS. Thank you, Secretary. I see my time has expired.

Chairman FRANK. The first questioner on our side now will be the Chairman of the Financial Services Committee Subcommittee on Capital Markets, who has been working hard on this issue, Mr. Kanjorski.

Mr. KANJORSKI. Thank you, Mr. Chairman.

Mr. Secretary, the white paper requires that the SEC and the CFTC make recommendations on harmonizing their statutes and regulations by the end of September. And, as you know, we have been meeting with the two regulators, yourself, and representatives of the Treasury Department over these last several weeks.

It seems they have made tremendous progress on many things, but it is clear that, on some things, they, themselves, will not come to a resolution. And I am just curious if you could give us some insight, particularly because of the timing of all this.

You mentioned four or five different positions people have taken, and I didn't fit in any of those categories. I am in favor of comprehensive reform, but, also taking our time to make sure we don't cause unintended consequences.

And, with that in mind, have you, in your mind, formulated what you would do, or have you considered a joint task force of Treasury and the Congress in a prepositioned position to start formulating, if they don't agree on certain issues, what positions we can take to help facilitate the moving of this legislation on a faster track?

Secretary GEITHNER. We would like to come to you with a recommendation before the deadline we put in the white paper, which was the end of September, because we know you want to move forward more quickly on this.

And I agree with you, they have made a lot of progress but they are not there yet. And what we are doing is working closely with both agencies to try to explore options and bring them together to a position both can support.

But, in that process, as you know, we are consulting very closely with both these Committees, so that we are working in parallel to a point that it is going to be, not just that we have them together with the Treasury on a common position, but that we are more likely to find the common ground that both your Committees can support.

But we are not quite there yet.

Mr. KANJORSKI. Well, I appreciate that. And, of course, anything that we can do on the Congressional side, we offer our assistance. Because I am getting a little pessimistic as to whether or not the deadlines we are setting are going to be met. And not that that would be tragic if they are not met, but we are causing great expectations constantly with these deadlines that make it look a little difficult, or perhaps the perception is that we are not being as successful as we hope we can be.

Mr. Secretary, have you given up, and has the Administration given up, on the long-term prospect of joining these two agencies together, the SEC and the CFTC?

Secretary GEITHNER. There are a lot of compelling reasons made by people in this room, and many others over a long period of time, for merging both those agencies. In our judgment it is a necessary condition and the most important and, in some ways the hardest, thing to do is to bring the underlying statutes and laws into conformity and convergence.

We think that is the most important thing to do, in part because, as your colleague Chairman Frank said, the critical test of whether we do enough to improve the system is going to be what we do to the basic constraints and incentives, the substance of regulation.

So what we proposed in the white paper to do is to begin with that task, which we think is going to be enormously difficult and complicated. And that would provide a better basis for the Congress to consider institutional reforms in the future.

Mr. KANJORSKI. So you are not cutting short the fact—you are anticipating that we are going to do these preliminary reforms, and then continue on over a series of years with better reform.

Secretary GEITHNER. Well, I think that is a judgment you would have to make. But, there is enormous value—and this is an enormously complicated task—in bringing those underlying statutes into conformity, so that you don't have different standards, different entities, different enforcement authority over what are economically very similar types of products.

Mr. KANJORSKI. All right. Thank you, Mr. Secretary.

Chairman FRANK. I thank my colleague, although the prospect of several more years of this is not the happiest that is before me.

The gentleman from Florida, Mr. Posey, is now recognized.

Mr. POSEY. Thank you, Mr. Chairman.

Mr. Secretary, I had a couple of questions I wanted to ask when you were before our Committee earlier, and each time something came up before I got to ask my questions. So, just to put things into proper perspective, I would like to pose a couple of them now.

The stimulus bill was advertised to reduce unemployment and help us get back on track. It apparently hasn't done that. I have seen some information which indicates, in fact, unemployment has gone up to about 9½ percent from below 8 percent, instead of having the other effect. And I know the Vice President, the other day, said that it was something that the economy—that no one had anticipated and that they misread the economy.

And I was just wondering where you think your plan went wrong.

Secretary GEITHNER. Congressman, thank you for raising that question.

I think if you step back and look at where we are today relative to where we were at the end of the year, we have achieved the critically important effect of helping slow the rate of decline in the economy, helped to stabilize the financial system. Business consumer confidence has improved very substantially. The rate of decline in economic activity globally has slowed and stabilized. Financial systems are starting to heal. The cost of credit, broad concern about catastrophic risk in the economy and the financial system has receded very dramatically.

Those are critically important signs of initial progress, and they are due entirely to the actions this Congress took and the Administration took to put in place the largest recovery program in peacetime in the United States.

The stimulus package is on its expected path, in terms of the rate of change, and in terms of putting money in the pockets of taxpayers, to provide substantial forms of assistance to states to reduce the risks that they are forced to fire tens of thousands of teachers, workers, and firemen. And there are very substantial investments in infrastructure products that have already started to take effect and will have their maximum impact on the economy in the second half of this year.

So my own sense is, and I think this is a consensus of broad-based economists, that there has been substantial improvements in arresting what was the worst recession globally we have seen in generations. And those are the result of the actions this Congress took, the Administration put in place, and complementary actions taken by governments around the world to, again, help address what the worst crisis we have seen in a long period of time.

Mr. POSEY. Mr. Chairman, the chart just indicates the opposite. It shows——

Secretary GEITHNER. No, I don't think that is true. I don't think that is true, Congressman.

If you look at the dynamics of all recessions, even as growth starts to improve and turn positive, unemployment tends to continue to rise. That is the inescapable natural element of recessions. That is not an argument for not acting very forcefully in the face of crises of this magnitude.

And so, I think, what the Congress did, what the President did was necessary and critically important, again, to reduce the risk that we see hundreds of thousands of further losses of jobs, we see millions of job losses beyond this point, and we see thousands more businesses fail unnecessarily.

Mr. POSEY. You know better than me how cyclical they are—anyway, the next question is, we know, even in our districts, banks have money to lend, but they are not lending it. People have money to buy a new car, but they are not buying them. People have money to take a vacation, but they are not taking them. Consumer confidence isn't what we would like it to be, and the money is not getting spent.

And, personally, I think it is because they don't know what is coming. The banks are afraid to loan it. They don't know what the next issue is going to be, and we are looking, really, kind of, for a plan.

Chairman FRANK. Let me just repeat again. If Members go right to the end of the time with their questions, the answer will have to be 10 seconds. But if Members want to have an answer, they are going to have to leave time for it.

Mr. Secretary, briefly.

Secretary GEITHNER. Households across the country borrowed enormous amounts of money relative to income in the run-up to this crisis. What the economy is going through is a necessary and very healthy adjustment, as families and the Government of the United States goes back to living within their means.

That is causing a greater contraction and demand for credit than we normally see in recessions. And you are seeing a very healthy increase in private savings behavior, I think, probably in response to that.

I think those are necessary healthy dynamics, although they will produce a slower recovery.

Chairman PETERSON. I thank the gentleman.

The gentleman from Pennsylvania, the Vice Chairman of the Committee, Mr. Holden.

Mr. HOLDEN. Thank you, Mr. Chairman.

Mr. Secretary, as you know, the majority of over-the-counter derivatives are traded here and in Europe. Have you been discussing your proposal with your European counterparts?

And if you can come to an agreement with the European Commission and the European Parliament follows suit, what is to prevent these markets to go to some other nation with a less regulatory regime to follow.

Secretary GEITHNER. That is a very important question.

We have been working very closely with them, and there is very substantial convergence in overall approach. And, I think, the broad strategy that we are going to embrace here will be embraced in the UK, will be embraced in continental Europe, will be matched by the other major financial centers of the world. And, again, I think they see a broad interest, as do we, as do these Committees, in trying to raise the basic quality of standards in these markets.

Now, of course, as many of you said, it is all in the details and getting those right. But we are trying to do something we haven't done in the past, which is to move in parallel with other countries, that we are not left with a position that we raise standards substantially here and we just find that risk migrates to other countries.

But, again, I am quite encouraged, and I think there is broad convergence in approach.

Mr. HOLDEN. But if we come to an agreement with the Europeans, what is to stop the markets from moving to Dubai, Hong Kong?

Secratary GEITHNER. Well, again, we are not going to stop with the Europeans. I think the important point is to say, in all the major areas of financial activity, you want to have global standards enforced more evenly, applied more effectively, for just the reason you said.

Mr. HOLDEN. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman PETERSON. I thank the gentleman.

I now recognize the gentleman from Virginia, the former Chairman and Ranking Member of the Committee, Mr. Goodlatte.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Secretary, welcome.

Sitting here in the august surroundings of the House Ways and Means Committee, with its fine audio system, and with our good friends from the Financial Services Committee along side us, some of us on the Agriculture Committee might say that they feel that they are sitting in "tall cotton."

However, I must say that, having said that and how much we appreciate you taking this time, I think this hearing is premature. The fact of the matter is that I very much agree with you that we need to have as much transparency in these markets as possible. But we also must have that much transparency and more in the deliberation of this legislation. It is critically important that you be able to answer questions from Members on both sides of the aisle about the specific details of legislation which does not yet exist.

So I would ask you first, would you be willing to return to meet with these two Committees and answer our questions when we actually have the substance of the legislation in front of us and can get more precise answers from you?

Secretary GEITHNER. I would respond to any invitation by your Chairmen to come before you and help make the legislative process work on the pace that is appropriate.

Mr. GOODLATTE. That is a good answer. And I would convey to both Chairmen my hope that they will make this an open and bipartisan process and assure us that, once the legislation is in writing, that we won't rush to mark it up without having the opportunity for the millions of Americans who are very much affected by it as well as their Representatives having the opportunity to ask the questions that need to be asked.

In particular, I would note that you had indicated you hope that the Members of the Committee would write legislation that would establish broad principles upon which, then, the various agencies would write the particularity in the regulations. But we don't even, at this point, have those broad principles in front of us to know how we think that process would work.

But let me ask you specifically about one area that is of considerable concern to me and many others. You told us that the SEC and the CFTC are still working on how best to divide up the jurisdiction over the OTC derivatives markets and dealers. When this division of jurisdiction and responsibility is finalized, does the Administration intend that each agency would exercise exclusive regulatory jurisdiction over their assigned area?

The exclusive jurisdiction provision of the Commodity Exchange Act has worked well to avoid regulatory duplication and conflict. And I would hope that it would be built into the legislation on OTC derivatives, as well. Can you confirm to me that it will be?

Secretary GEITHNER. Good question. There is a lot of merit in that approach. And I would say that probably because of the precedent established, that is the presumption we are going to bring to this.

But, again, until we see the full package and have a chance to walk you through that, I don't want to respond in detail—or I don't want to get ahead of the delicate, careful process we are trying to work through now with those two agencies.

Mr. GOODLATTE. I see that you have the same problem that I have with this process, then. And I wonder if you could——

Secretary GEITHNER. Well, yes Congressman, of course, I agree that it is going to be all in the substance and the details of this. And we do carry the burden of presenting before you detailed proposals in legislative form so that you can consider those recommendations. And we are going to deliver on that commitment.

Mr. GOODLATTE. I thank you.

I wonder if you would be willing to assure the Committees that you would get back to us on that specific question in writing once you have the information in front of you that would enable you to——

Secratary GEITHNER. Absolutely. I think that when we propose our recommendations on how to solve these jurisdictional questions, a necessary part of the answer will be a response to the question you raised.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Chairman PETERSON. I thank the gentleman.

And I would just remind the gentleman that we marked our bill up and passed it out of the Committee in February under an open process. It has been out there since then. I think we can assure you that we are going to continue that open process.

We are having a hearing here today, and we are probably not going to get around to this until, maybe, September, so we are being as open as we can be.

Mr. GOODLATTE. Mr. Chairman, if you might yield on that point, would that be an indication that we might actually have a hearing on the legislation itself rather than the subject?

Chairman FRANK. Of course. I am puzzled by the inference that we didn't plan to do that, and I am puzzled by the argument that it is premature to have a hearing. I didn't subpoena the gentleman here. He is free to go off and do other things. But I would think having a hearing well in advance of when we actually start to get the legislation would be seen as a useful part of the process, to begin to open the subject up. Of course there will be a hearing on the bill itself.

Mr. GOODLATTE. If the gentleman would yield, if that is coupled with a follow-up hearing on actually what we are going to do, then I would agree with the gentleman.

Chairman FRANK. Yes. But the gentleman said it was premature. I must say, that is an odd accusation that now——

Mr. GOODLATTE. It is not an accusation. It is a question.

Chairman FRANK. Well, "premature" is not a question. It is at least a description. Maybe the gentleman regards it as something good to be premature; I have never done that. But the point is that we are having a chance now to air the questions.

I now recognize the gentlewoman from California, Ms. Waters.

Ms. WATERS. Thank you very much, Mr. Chairman.

There is substantial attention given to OTC derivatives in your testimony. And, as you know, I have been talking a lot about credit default swaps. And I remember what you told me the last time I asked you; you said that if we ban credit default swaps, they will just emerge in another way, that the sophistication and creativity of those who deal in these markets is such that they will just find another way to do what they want to do.

Basically, what I am reading from your testimony is that you think that credit default swaps are necessary. However, this country did very well without them for a long period of time.

If credit default swaps do such a good job at diffusing risk, why did so many financial institutions lose so much money, even when they were using credit default swaps as a hedge? Doesn't this prove that these products are more dangerous than originally thought? And why not ban credit default swaps?

Secretary GEITHNER. I think, as I said in my testimony, the principal risk these instruments presented came from the fact that a set of institutions wrote a lot of commitments without capital to back those commitments. And the regulatory authorities of the nation charged with policing these markets to prevent fraud and manipulation were not given authority over those basic markets. We are proposing to address those two critical features.

Now, this country has decades of experience with derivative products of all classes. They provide, as many of your colleagues have said, an important economic function in helping companies and businesses across the country better hedge against their risk. And, our responsibility and job is to make sure that those benefits come with appropriate protections for financial stability of investors and consumers. And that is the package of reforms we have proposed.

Ms. WATERS. Mr. Secretary, you are talking in your testimony about all of these steps that it will take in order to supervise and manage and oversee credit default swaps.

If you have to work that hard at trying to make them more substantial in terms of having the collateral to back up the risk, why do you have to do them at all, if you have to work this hard at it?

Secretary GEITHNER. I don't think we have to work so hard, but Congress has to legislate the authority to make that possible. And that authority didn't exist before, and we are proposing Congress provide that authority.

But I don't think it is a challenge beyond the capacity of the people in this room, or in the Congress, or the regulatory authorities to do that.

Again, we are proposing, in some sense, to extend and recreate and apply the protections that have existed in the range of other markets to these markets where they did not exist. And that is not a task that is too complicated for us to manage.

Ms. WATERS. Thank you, Mr. Chairman. I yield back.

Chairman FRANK. The Ranking Member of the Financial Services Committee, the gentleman from Alabama, Mr. Bachus, for 4 minutes.

Mr. BACHUS. Thank you, Mr. Secretary.

Mr. Secretary, on more than one occasion, you have said we are not going to make the system stronger by banning products. Doesn't the proposal give that authority to the Consumer Finance Protection Agency, and do it without any review or oversight?

Secretary GEITHNER. Well, it is true that, in the consumer credit area, where we have seen just terrible examples of predation and failure of basic underwriting standards, basic protections for consumers, we are proposing to give this new agency comprehensive rule-writing and enforcement authority. And, in this context, we would expect them to proscribe certain types of marketing practices; and, that would be appropriate, given what we have been through. That is an approach that has, sort of, come in lots of other areas before.

But I do think it is important to recognize—and if you look at what the Congress of the United States did in the wake of the Great Depression, we put in place this comprehensive set of reforms to help protect consumers and investors and depositors to ensure the integrity of market functioning.

What we are proposing to do is in the spirit of that. In many ways, the big mistake we made as a country was we allowed a huge array of activity, financial activity, to build up and exist outside those protections. But——

Mr. BACHUS. Mr. Secretary, they would be allowed to ban products, though.

Secretary GEITHNER. They would be allowed. There are some consumer practices that we believe should not be permitted. But we are proposing that the Congress establish the basic standards that would govern regulation in those areas.

Mr. BACHUS. So their actions would have to be based on existing statutes? Or could they go beyond those?

Secretary GEITHNER. No. No, I think we are going to propose that you legislate a framework of standards that would help shape and govern regulation and rules that that agency would write and enforce. But that is a responsibility that you would have to set initially.

Mr. BACHUS. You know, you have said—I am just following your testimony—sometimes you don't believe in banning products. But you have said they can prohibit certain products if they are not appropriate for consumers. Now——

Secretary GEITHNER. Well, Congressman, if you are asking, again, whether we think it is appropriate in the consumer protection area—again, this is the marketing of financial products to individual consumers—there are some practices that I do think should be proscribed.

Mr. BACHUS. Right.

Secretary GEITHNER. But, again, I think the statue would have to describe, in some sense——

Mr. BACHUS. I am not arguing with you. I am just—but, now, what would be the determinant on whether a product was appropriate? What if it was appropriate for 95 percent of the population but not for five percent?

Secretary GEITHNER. Well, I think that is exactly a good way to frame the basic dilemma. And, the centerpiece of our proposed approach to reform in this area is to encourage more simplicity and standardization so that consumers have the choice of a more accessible, easier-to-understand suite of financial instruments. But they would still preserve the option, in our proposed frameworks, to adopt or embrace a different type of product, a less standardized product.

So I think there is less contrast in the basic philosophy on the consumer side and this other area than I think you are implying.

Mr. BACHUS. Who would review their actions? You know, with a lot of the Fed's actions you have said the Treasury would have to have approval there. Who is the reviewing authority over the Consumer Finance Protection Agency?

Secretary GEITHNER. Well, Congressman, I am not a lawyer or a student of administrative law, but my belief in this context is the Congress is accountable for, and these agencies would be accountable to the Congress under the basic model that exists for the SEC——

Mr. BACHUS. Would we have to approve their actions?

Secretary GEITHNER. Not their individual actions, no. But the statute would establish, as it does for the CFTC and the SEC today, that basic relationship.

Mr. BACHUS. All right.

Let me ask you something else. Back in 1998—and I will just ask this—Larry Summers testified in the Senate against the notion of regulating derivatives. Among the things he said is, “It would cast the shadow of regulatory uncertainty over an otherwise thriving market, raising risk for the stability and competitiveness of the American derivatives trading. Even small regulatory changes could throw the whole system out of whack.” That was after Chairman Boren proposed regulating derivatives.

What has changed? Or do you have those same concerns today?

Secretary GEITHNER. I think there has been dramatic changes in the basic scale, design, and development of those markets. And even though, as I said in my testimony, the failures in those markets were not the principal cause of this crisis, they did cause substantial damage. And I think that justifies substantial reform.

Mr. BACHUS. Sure. And I am not saying it hasn’t changed. But I guess I would say, do you still share some of his concerns?

Secretary GEITHNER. The proposal the President laid out reflects—and, of course, I played a substantial role in shaping those proposals—my judgment, our collective judgment about what is appropriate, given the risk we have seen illustrated by this crisis.

Chairman PETERSON. The gentleman’s time has expired.

Mr. BACHUS. Thank you.

Chairman PETERSON. The Subcommittee Chairman from Iowa, Mr. Boswell.

Mr. BOSWELL. Thank you, Mr. Chairman. And thank you both for this hearing.

Mr. Secretary, you are well aware that the market price in agriculture has been very volatile, and it is a concern. Experts tell me that the population of the world is growing by 90+ million per year. Food is important.

And I just want to say this: Please remember in all those discussions you have, that we have—we are envied around the world. We have the most plentiful, the safest, and the least expensive food in the world because Maxine and I—she lives in LA and I live in Iowa, but we contribute the same and we get something. We get what I just said. So keep that in mind.

Now, I am concerned about over-the-counter, all these derivatives transactions will need to be registered with some agency. Would this include rural entities using derivatives like grain elevators?

They have to hedge; they have to be careful. They get caught out there in a weak position, and they can go down, and there is no market out there in the marketplace for the producer.

Secretary GEITHNER. Congressman, if I understand your question correctly, we are preserving, and I think it is appropriate to preserve, the ability of grain elevator operators, a whole range of companies and businesses across the country, to make sure they have the ability to hedge against this unique and specific risk they face.

But, again, the markets as a whole, even in those customized areas, need a greater level of transparency, oversight, and protection.

Mr. BOSWELL. Well, thank you.

And, Mr. Chairman, I am going to use my remaining time to make a statement.

I am getting frustrated. I just heard my colleague from Florida a minute ago ask him, where did you fail? Now, wait a minute. Let's just review this for a minute. We all ought to be involved in making this a success. Dammit, it is time to get together.

Here we are, just review a little bit. Let's go back. Last Administration, $700 billion was asked for us to catch things up. And then unbeknown to many of us, the Fed spent $800 million. That is $1.3 trillion. And so, by as early as February, I believe it was, folks are saying across the aisle, "Look what you have done to us." Horse feathers. That is just not the way it happened.

Now, let's think of this. Dr. Kagen, I am looking right at you. Recently I had a loved one at the Mayo Clinic. There were many doctors, and I asked them time and again, "Is getting well thinking you can get well? Is that about 90 percent of it?" And every one of them said yes.

Well, this country is in that position. We have to get well. And we ought to all be hoping and praying that we are going to make this thing work, and quit picking fault with it and saying why it won't work. And then if you want to politicize afterward and take over the majority, go for it. But let's get this country back in shape, and let's do it together.

Chairman PETERSON. I thank the gentleman.

One of our Subcommittee Ranking Members, Mr. Moran from Kansas.

Mr. MORAN. Mr. Chairman, thank you.

Secretary Geithner, it is too infrequent that we have the opportunity to hear from you and to have a dialogue. And I am going to ask questions, or at least ask you to respond to some thoughts that I have somewhat unrelated to the topic of today's hearing.

But most of the banks in my state did not contribute to the financial crisis that our country faces today. They did things right. We still have bankers who say, "No, I am sorry, I can't make this loan; you can't afford to repay it."

And yet, my banks, which ultimately affect my constituents, are facing an increasing and uncertain regulatory environment. Examinations are becoming perhaps more frequent, but the uncertainty of the exam is clearly there. The FDIC insurance premiums have increased. And we now hear of a new consumer financial product safety commission with potential additional regulations upon banks.

And, again, I want to stress that the banks that we have at home are not the financial institutions that we have been engaged in in regard to Wall Street.

The consequence of this uncertainty is direct upon the economy. I have had this conversation with officials at the Fed. And, while the Federal Reserve has lowered interest rates in hopes of encouraging consumers to borrow money and to consume, the regulatory environment, particularly with the examinations, has discouraged banks from making loans.

So we are at cross purposes, it seems to me, as we try to improve the economy. That uncertainty lends itself to borrowers that I visit with who say, "We are current, our company is making a profit, and yet our banks can't tell us whether they are going to reauthorize/renew our loans."

In addition to that, it means potentially higher interest rates, which will reduce the demand, therefore potentially stifle the economy. And, ultimately, the increasing cost of being in the banking business means that we will see increased consolidation. And, yet, one of the theories, at least that I think we have operated under, is that we want to avoid institutions that are too big to fail.

And, yet, many of the things, it seems to me, that are happening at the Department of the Treasury and within our financial system is increasing the role for consolidation. Increased cost of being in business means that we are going to spread the cost, as best we can, among a larger group of banks. And so we see continual consolidation in the industry.

My point is that, while it is damaging to my bankers, it is ultimately damaging to their borrowers, which is ultimately damaging to the United States economy. And I would appreciate any response that you might tell me that would give me comfort that that is recognized in the counsels that you are engaged in.

Secretary GEITHNER. It is absolutely recognized, and it is a significant issue of concern.

But, what is causing those pressures on both borrowers and banks is the fact that large parts of the financial system in this country just took on too much risk during the boom. And the costs of that—it is fundamentally unfair, but that is what happens in financial crises—fall not just on those who took too much risk, but they fall on a bunch of businesses and banks across the country which were very responsible and prudent.

And that is why these things can be so damaging. And that is why it is very important that we do everything we can to put a better foundation for recovery in demand and growth, and try to make sure that the financial system has capital where it is necessary, and that these markets for credit start to get moving again. And that is the basic philosophy that has underpinned everything we have done.

You are also right that there is a risk in financial crises that people overcorrect; that, after a period of taking on too much risk, that they take too little. People that got way overextended pull back too much. And that can cause, also, a lot of collateral damage. And, again, that is the basic rationale in a financial crisis for trying to make sure you do as much as you can to provide enough support for the economy to get back on track.

But, I am very much aware of the concerns you expressed. I believe that the principal bank supervisors are, too. They are carefully managing those risks. And you are also right that any time you think about reform to legislation in the financial area, that is going to come with a period of uncertainty. We need to minimize that uncertainty.

And, that is one reason why we want to bring clarity, relatively quickly, to the rules of the game that govern our financial system, going forward. If we were to wait years to do this, the markets would be left with a greater period of uncertainty, and that might deter more lending and risk taking.

Mr. MORAN. I simply would ask that you continue to differentiate, or begin to differentiate, in my opinion, the difference between the significant financial players, and those that are out there in the business every day of making loans to more consumers to buy an automobile, to purchase a home, to plant a crop.

It does seem to me that differentiation between those kind of banking institutions and the financial institutions ought to be— they ought to be treated differently. And I would hope that that would be the case.

Chairman PETERSON. The gentleman's time has expired.

Secretary GEITHNER. Mr. Chairman, could I respond very, very briefly?

Just want to say, I completely agree. And the approach we have taken is to apply more exacting standards to the largest institutions than we are to the 9,000 banks across the country that are in a somewhat different set of circumstances.

And we are very committed to make sure that we have preserved that basic balance. A great strength of our financial system is that we are not a nation of three banks, or four banks, or five banks, or ten banks, which is true across many industrial economies. We are a nation of 8,000, 9,000 very diverse financial institutions. And that is a source of resilience and strength, and we want to preserve that.

Mr. MORAN. Thank you for your answer. Thank you for listening to my point.

Thank you, Mr. Chairman.

Mr. KANJORSKI [presiding.] The Subcommittee Chairman of Domestic Policy, the gentleman from North Carolina, Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

Mr. Secretary, I am over here, right in front of you, behind this tall guy.

Last year, our mutual good friend, Rahm Emanuel and I, and Sue Myrick, our bipartisan cosponsor, introduced a bill calling for a pilot program to execute interest rate swaps on a transparent electronic execution platform. People perceived that he was from Chicago and was the CFTC guy, and I was from Charlotte the banking side guy, and we came together on this notion that that was a good thing.

I note that that is an important part of your proposal this year, and I want to ask you two questions about it. This is not a clearinghouse or an exchange. There is something before you get to that. And it seems to me that the regulators could already be mandating this part of what you have proposed in legislative form now.

So the first question is, do you see that the regulators—Comptroller of the Currency, the other regulators—are really aggressively pushing that notion to your satisfaction, even before this legislation is passed?

And, number two, I have been somewhat disappointed that, because we have control over Fannie and Freddie, no direction has really been given to them to use aggressively these electronic trading platforms. So I would like to have your assessment of whether you think that would be a good idea, and when that might be in the works.

Secretary GEITHNER. Congressman, I thought the basic spirit of your proposals when you proposed them were right. And you are right that we have adopted the basic recommendation, not only to have central clearing of standardized products, but we want those to be traded on either organized exchanges or on transparent trade execution systems, for the reasons you proposed.

I don't believe, though, that we can move substantially in that direction without the legislation being clarified. So my own sense is we need to get the broader legislation in place before we can bring about this broad transformation in that market activity.

I do believe, though, that the economic benefits of, not just central clearing, but more exchange-traded and transparent electronic trading for some traded products in these areas, is are going to be very compelling to the users in these markets. So I believe, once the legislative framework is clarified, that you are likely to see much, much greater use of those platforms.

Mr. WATT. What about the Fannie and Freddie——

Secretary GEITHNER. Including by all users and beneficiaries of those types of products.

Mr. WATT. I mean, we have control over Fannie and Freddie now. Wouldn't we be in a different position with respect to them to insist on a more aggressive, forward-looking approach to this than we would be, possibly, with private-sector entities that are under regulation?

Secretary GEITHNER. Well, in many ways, because of what Congress proposed, the legislative framework over Fannie and Freddie has come closer to match what exists for banks and regulated financial institutions. But I think you want the market to move in this direction as one. And, again, I think there would be good risk management benefits for moving in this direction and good economic benefits.

So, once we have the broad framework legislated, I think you are going to see very substantial movement in that direction.

Mr. WATT. Thank you, Mr. Chairman. I yield back.

Mr. KANJORSKI. Thank you, Mr. Watt.

The gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for coming.

We had a little bit of a dialogue, the other night, about capital and equity, and I want to go back to that. Because when we look at the standardized and the customized transactions, the question I have is—I hear you talking about margin requirements, capital equity.

In traditional commodities, the clearinghouses set the margins for clearing those transactions. The regulator then determines whether the clearing agency has adequate capital for the activities they are involved in.

As we move to the trading of these derivatives, do you see that same structure? Because, sometimes, I hear you saying that the regulator would start setting the margin requirements for these transactions. And I wanted to be clear about my understanding of where you are on that issue.

Secretary GEITHNER. Congressman, I think you said it right. I think for central counterparties, central clearinghouses, they design the margin rules, they design the financial safeguards against default by a member, by a participant.

The regulators have an important obligation to ensure, because central clearing can concentrate risk, that those safeguard margin cushions are adequate. That is an important obligation of the CFTC and SEC under our basic framework. And you want to make sure that people don't compete, take advantage of the existence of multiple agencies to try to attract volume and activity by having imprudently thin margins and cushions in central counterparties.

For those products that are not centrally cleared, it is very important that there is capital margin required through supervision and regulation against the risk those positions impose.

So I think you need to have that basic balance. But it depends, the approach varies depending on whether it is the centrally cleared stuff or the products where the risk is still bilateral.

Mr. NEUGEBAUER. And looking at the customized products that aren't going to be cleared in this regulatory structure that you are going to propose, where would the margin requirements and capital requirements for the customized transactions, where do you see that falling?

Secretary GEITHNER. I think that is a judgment that is going to have to be reached in cooperation between the SEC, the CFTC, and the Federal Reserve. Because, again, I think you are going to have a bunch of different entities in these markets; they are going to have different regulatory authorities. Well, we want to make sure that there is going to be a common approach that is sufficiently conservative. That is a similar approach we bring to thinking about the design of capital requirements generally.

Mr. NEUGEBAUER. How would you—with multiple entities like that involved, what kind of coordination needs to happen so that—as you have alluded to a couple of times, shopping places to do business. So if you have the Fed, the SEC, CFTC trying to have jurisdiction over a particular clearing opportunity or a particular customized transaction, how would that coordination happen?

Secretary GEITHNER. Better than it has. It is going to have to be substantially better than it has.

Again, the important imperative is there has to be an appropriately conservative capital margin requirement set across the core institutions in these markets and the areas where risk is centralized. And that has to be—and this is critically important—has to be enforced more evenly.

If you just take the example of banks and thrifts, they had nominally similar capital requirements. Because of very different enforcement regimes, a lot of banks chose to become thrifts. A lot of institutions were set up to take advantage of what they thought were lower, weaker enforcement standards.

So you need both stronger standards set uniformly with more consistent enforcement across the basic entities. And it is harder to do than it is to say.

Mr. NEUGEBAUER. Well, you wouldn't foresee forcing, requiring these customized transactions to have a third-party counterparty to hold those transactions.

Secretary GEITHNER. I think the definition of a *customized product* in some ways is that it is not so standardized that it could be centrally cleared. The risks are complicated enough that a clearinghouse would not want to, or would not believe it could, adequately manage those risks.

Now, that is not a detailed enough standard to divide the line between standardized and customized, but I think that is the way to think about the economic difference between them.

Mr. NEUGEBAUER. Thank you.

Chairman PETERSON. The gentleman's time has expired.

Now recognize the Chairman of the Livestock, Dairy, and Poultry Subcommittee, from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

I am over here, Mr. Secretary, over here in the corner. I would like to see if I could squeeze in a couple of questions.

First of all, I have a concern that your proposal could very well force non-financial dealers to meet capital requirements in order to provide legitimate managed risk. But, given that these non-financial dealers do not have depositors, unlike large financials, and a low or no systemic risk profile, is it possible that such a requirement could unintentionally create a bank monopoly in the over-the-counter derivatives market? And wouldn't that reduce competition, reduce liquidity, raise prices, and increase systemic risk by consolidating the markets?

Secretary GEITHNER. I don't think so. But you are right; if that were the result of what we are proposing, that would be a subject of concern, both to us and to many other people.

But maybe I could respond this way. The centerpiece of our proposals is to make sure that the major participants in these markets, because of their importance to the economy, be held to more exacting standards, higher, more constraining requirements for leveraging capital in the future.

And that is one way to protect against the risks that both you and Ranking Member Bachus have pointed out. So, more exacting requirements for the major participants will help reduce that risk.

Mr. SCOTT. Well, why would we not just have those capital requirements limited to firms whose failure could, indeed, create the systemic risk to the U.S. economy?

Secretary GEITHNER. I think, again, you need to have capital backing risk where risk is taken and where entities are taking short-term liabilities, borrowing short-term and taking longer-term risk. That requires capital to protect the system.

If you don't apply a uniform set of prudential requirements around those entities, then what will happen is the risk will migrate to those parts of the system where there are lower standards, as we have already seen in this financial crisis. So that is important to guard against.

Now, that doesn't mean you have to be completely comprehensive, but you have to capture enough of the core participants that you avoid that risk.

Mr. SCOTT. Another area that I am concerned about is, we are going to be doing some sweeping limits on the trading of energy derivatives. Take, for example, oil, which to me is what has really been the driving force behind the call for increased regulation of over-the-counter markets.

Oil, as you know, is globally traded, and its price is set not solely by activities in the United States market, but by other markets. So I find it kind of dubious that we can control speculation and hold down the price of oil simply by unilaterally regulating our markets.

Would not businesses simply move to less regulated markets and, in effect, diminish our opportunity to legitimately hedge in the domestic markets?

Secretary GEITHNER. I share that skepticism and concern, and I think you are right in seeing it that way.

I think what the CFTC Chairman proposed the other day, and what is an appropriate approach to think about policy in this area, is to look for ways to limit volatility.

And it is very hard to not look at the last 2 years of pattern in the global energy markets, even though there has been such enormous shifts in confidence about the strength and weakness of the global economy, and not to believe we have seen a level of volatility that has been damaging, fundamentally, to the capacity of businesses to manage risk and damaging to confidence.

And so it is worth trying to see whether you can, through better disclosure, limit that risk. Hard to do. Lots of people have tried it unsuccessfully. But, you are also right that, if you are going to do that effectively, you have to try and do it in a common approach where oil and other commodities are traded globally.

Mr. SCOTT. So have other countries taken steps, or have there only been promises or loose commitments?

Chairman PETERSON. I apologize. Nobody else has the timer but myself. The gentleman's time has expired. So thank you, Mr. Subcommittee Chairman.

Mr. SCOTT. Thank you.

Thank you, Mr. Secretary.

Chairman PETERSON. And I would like to—well, I have one more on my side, Mr. Chairman.

Chairman FRANK. Oh, I didn't know which capacity Scott was in. Scott's a two-fer, not for the first time in his life.

Chairman PETERSON. We had a two-fer over here, too, with Mr. Neugebauer.

I would just like to announce that the Secretary has to leave about 1:10 or so. And there may be votes, I don't know, 12:30, 12:45. If that is the case, that will probably be the end of this. So I would just encourage Members, even though we had set this 4 minute limit, if you could keep it to one question, we will try to get through as many Members as we can.

The gentleman from Alabama, Mr. Rogers.

Mr. ROGERS. Thank you, Mr. Chairman.

And thank you, Mr. Secretary, for being here and for your service.

I want to go back to the answers you gave Mr. Posey a little earlier. You know, I live in Alabama, and we have been devastated economically with the car industry. You know what is happening there with all the supplier plants. And I was on the phone this morning with a tractor dealer who is a large tractor dealer in Birmingham, who told me he has invested $70 million in recent years opening new stores throughout the South, but that he has completely lost confidence and is not going to open any more. He has had to lay off 250 employees, and have others take early retirements.

I have another company in my district called Metalcraft, which makes wrought iron railings, the largest one in the world, for outdoor furniture. They are having to go out of business because their bank, which is one of the banks that received TARP funding, has changed their lending criteria. And even though this is a profitable business, they can no longer get capital to work.

I hear those stories, those anecdotal stories, all around my district of how we are in a crisis of confidence. People are scared to death. Even the people who haven't lost their jobs are worried they are going to.

So when I hear you answer Mr. Posey's question with, "Business and consumer confidence has improved greatly." "There has been a substantial improvement in arresting what is the worst recession in history," how do I reconcile that with what I am seeing in the real world?

Secretary GEITHNER. I think you are right, Congressman, that across the country, not just in your district, you still see businesses and families under enormous financial pressure. And you are still—and we are going to be living, for some time, with the consequences of digging out of this mess we started this year with.

And so, in acknowledging and pointing out the fact that we have made very substantial progress in trying to repair the damage caused by this crisis and lay the foundation for recovery, we do not yet have an economy that is growing again. And, it is likely that this is going to take a while to come out of.

But, that underscores, and the examples you pointed out, underscores the importance of this government doing everything we can to try to mitigate these pressures. And that is what the Recovery Act is designed to do, and that is what the programs we have done to help get credit flowing again are designed to do.

And they are having their necessary desired effect; they are starting to get some traction. But you are absolutely right to emphasize that we have a ways to go. And, again, this is in families across the country that still feel they are under enormous financial strain.

Mr. ROGERS. What timeline is "a while," in your mind?

Secretary GEITHNER. Well, again, this was a—it took us a long time to get into this. You know, as a nation, we just were living way beyond our means for a long period of time. People took on way too much debt. And it will take some time to work through that.

But we are making progress. You have already seen a very substantial increase in private savings. As I said, that is a healthy, necessary process. Our current account deficit, which approached seven percent of GDP only 2 years ago, is now under three percent of GDP.

We are starting to see this country get back to a point where we are going to have a stronger foundation for sustainable growth, going forward, but it is going to take some time.

Mr. ROGERS. And that is a great point. You made the statement also a little while ago in answering one of the questions, tightening of spending and greater rate of savings is a healthy trait that we are seeing in our country.

Why are we not seeing it in our government? That is what folks back home want to know. We are spending up here like drunken sailors, and it is all borrowed money. Why is it good and healthy for individuals and small businesses, but why aren't we practicing what we preach?

Secretary GEITHNER. I think, Congressman, that is an excellent question. We could debate this for hours.

But the lesson of the financial crisis here in the United States, and around the world, is that when you face a loss of confidence and a loss of demand of this magnitude, when you have a financial system on the edge of collapse, the only path to mitigate the damage is for the government to do what this Congress did and this government did, which was to try to make sure you were providing support for investment, for targeted tax cuts, to try to get demand going again.

That is necessary but not sufficient. It also requires making sure you stabilize the financial system and help get credit flowing again. And that is the basic strategy that this country, fortunately, has adopted.

Mr. ROGERS. Thank you.

Chairman FRANK. Thank you.

And let me just say—and we only have the one timer—what we should do is a tap when a Member has 30 seconds left, because it is tough. So the next time, for questions, if you hear the one tap that will mean 30 seconds. It will give people a chance to wind up.

And next is the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman.

Thank you for your service.

Let me ask—I learned, coming in here, that there is always a question of, and trying to think forward so that we don't get involved in unintended consequences and things of that nature. And there are two concerns that I have and I will give examples of.

For example, many small businesses use derivatives for legitimate risk management purposes that pose no systemic risk to the system. And many of these may opt out of, I am afraid, of hedging interest rates and currency risk if oil trades are moved to exchanges, and they can no longer customize and/or require homogenous collateral requirements. And this may lead to smaller firms doing more riskier things. So, that could be an unintended consequence.

The concern with the dealer banks who rushed to establish proprietary exchanges and pushed their transactions to owned clearinghouses or exchanges, which would create—seem to be a strong incentive for this and could potentially stifle competition in the market and further concentrate the market, which could create more of a systemic risk.

I was wondering if you could give us your thoughts.

Secretary GEITHNER. I think you said it well. I think the risk is overstated that if we move to greater standardization and greater sense of clearing, more exchange trading, more trading on electronic trading platforms, that that would make it harder and more expensive for businesses to hedge risk. I think that is quite unlikely. But we are preserving, as I said several times, we are preserving the ability for small businesses and large businesses to engage in more customized, more tailored hedges against the specific and unique risks they face, in the event the standardized products don't provide adequate protection. So we are preserving that capacity. We think it is important for the economic benefits you laid out.

Mr. MEEKS. Let me just ask this question: There is some concern that pushing all derivatives to clearinghouses or exchanges will create the natural monopolies. I just want to talk, have a concern about that. But simply reducing the innovation factor and proper risk management system, should we consider creating some type of utility type clearinghouse?

Secretary GEITHNER. I am worried about the same risk. But, again, I want to make clear, we are not proposing to force all derivatives onto exchanges, in part, because of the risks you pointed out. We are proposing to make sure that the standardized products that can centrally be cleared and traded on exchanges and electronic trading platforms, that more of that happens, because we think that will create a more stable system. But we are still in a—with careful oversight, appropriate capital requirements, authority to address foreign manipulation, we also want to make sure there are adequate protections over the more tailored, customized derivatives area.

Mr. MEEKS. Thank you. I yield back.

Chairman FRANK. The gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Mr. Secretary, thank you. Your opening comments were to the tune of those people who think that we are moving too soon or that we don't need change right now, or your third point was that smarter regulations might basically destroy innovation. Those people you said were——

Secretary GEITHNER. Those people are not in this room.

Mr. GARRETT. Excuse me?

Secretary GEITHNER. They are not in this room.

Mr. GARRETT. Well, or you are saying they want the *status quo*. I appreciate that last little comment, because there are people here in this room who think that maybe we don't want to move too soon, that we do want to be thoughtful about this. And maybe somebody else, before I came here, said that we want to be able to read and digest the entire legislation before, and some say that we want to do it at the appropriate time. And you are in agreement with that?

Secretary GEITHNER. Well, I am absolutely in agreement that we need to get this right. I am absolutely in agreement that this is enormously complicated. I think you need to look at it comprehensively. You need to look at the entire package before you evaluate.

Mr. GARRETT. To a point that you and I agree on, with regard to naked CDSs: Some people around here demonize these things. Would you demonize naked CDSs, or do you think that they actually play a valuable role that we should not be just totally outlawing them? I think we agree.

Secretary GEITHNER. I am not sure I want to use the term *demonize.* I am not sure I would spend a huge amount of time extolling their merits. But, like across our financial system, it is important that people have the capacity to hedge risks that they face.

Mr. GARRETT. Would you want to eliminate them?

Secretary GEITHNER. I do not believe it is necessary or appropriate for us to abandon them. But I want to underscore, as we have said, we do believe there needs to be comprehensive oversight over these markets, both the standardized and the customized.

Mr. GARRETT. And we do that because we want to get to the underlying causes that brought us to this morass in the first place. Right?

Let's take a look at one of those pictures which is always on the front page, the AIG situation. The AIG situation, with the derivatives that they were involved with there, the underlying problem there was, what, mortgage-backed securities. Right?

Secretary GEITHNER. Right.

Mr. GARRETT. Those instruments, as far as I understand, would not be by any stretch of the imagination a standardized product. Is that correct?

Secretary GEITHNER. I am not sure which way you are going with this. But, you are right to say in the AIG case and in the case of the monolines, the largest part of the protection they wrote, and ended up with, could not back with capital were credit protection on real estate-related asset-backed securities.

Mr. GARRETT. But the products that they were dealing with would not be defined as a standardized product that would necessarily be able to go through a clearinghouse. Is that correct? Because you are dealing with these underlying mortgage-backed securities which are all over the spectrum, all over the field; and, therefore, to try to say we are going to standardize them might be problematic.

Secretary GEITHNER. I agree. But, again, our proposals would get at the core of that specific problem, though, by trying to make sure that there is sufficient capital held against commitments financial institutions make to hedge against certain risks, regardless of how they do it. We are addressing the core of that basic problem.

Mr. GARRETT. And you would do that, though, with the AIG type situation: not because they would be able to go through the clearinghouse over here and be standardized and create liquidity over here, but because they would be nonstandardized products and you would raise stricter capital requirements in order to facilitate them.

Secretary GEITHNER. And on the firm as a whole. But, again, the capital is central to this. A core part of what brought the system to the edge of collapse was inadequate capital against a range of commitments, banks, and institutions like AIG made.

Mr. GARRETT. Okay. One last area in 30 seconds: In the energy field—I don't know if anybody else talked about this. Is it not problematical for those who deal in the energy area to have those capital requirements, to potentially have the elimination of the naked swaps as well because of the nature of that industry and the nature of the trades of those and the liquidity, and the inability to put the capital behind it, at least under the system that we have now?

Secretary GEITHNER. I don't think what we are proposing has that risk. But, of course, we will look carefully at any concerns in that area. I don't think what we are proposing has that risk, though.

Chairman FRANK. I apologize, I didn't pay attention to the 30 seconds. I apologize.

Mr. GARRETT. You want me to keep going?

Chairman FRANK. No. I have never had that motion.

Chairman PETERSON. The gentleman from California, Mr. Costa.

Mr. COSTA. Thank you very much, Mr. Chairman. I thank both Chairmen for holding this important hearing. And thank you, Mr. Secretary.

I want to focus my questions in the area of commodities. I represent a large agricultural area, and obviously commodity trading is very important. You have spoken about a good way to avoid the future AIG situations as to ensure that all parties have a stake in the game, or skin in the action, or whatever you want to call it—skin in the game, I guess. I think that is more achievable in terms of the financial institutions, but commodity hedgers don't generally have the same access to cash and capital in order to be a player in these markets. Their assets oftentimes tend to be tied up in reinvestments and their own company growth.

What sort of impact do you think this is going to have on capital requirements on nonfinancial entities that have an appropriate role to be engaged in this market and to have the access to it?

Secretary GEITHNER. Congressman, we will take a careful look at that. And, again, as people see the details of these proposals, they raise those concerns, then we would be happy to work with you on how to address that.

You know, we are not trying to—we want to get the balance right. And, again, a systematic source of problems across our finance system was inadequate capital, people taking risks that they did not understand, could not support. So we want to make sure we fix that. But we are going to try to be careful to get the balance right, and we will be happy to respond to any detailed concerns raised when you see our proposals.

Mr. COSTA. The balance, I agree with you, we have to get it right. But is it possible you think that in terms of trying to do that, that we are consolidating these types of trades in the hands of financial institutions that do have access?

Secretary GEITHNER. Again, I don't think that is the likely consequence of what we are proposing. But, again, we would be happy to respond.

Mr. COSTA. Because I am concerned about consolidation, getting back to the point of being too big to fail. I don't want to go there.

Secretary GEITHNER. I share that concern.

Mr. COSTA. We have been there.

Secretary GEITHNER. I share that concern. And, again, I don't think our proposals carry that risk. But we would be happy to respond to any concerns raised by them.

Mr. COSTA. In the same ballpark, in follow-up to Congressman Scott's question, you talked about capital requirements being uniform between financial and nonfinancial traders. How would you visualize that taking place between commodities, a company continuing to participate in the market, if they are required to have an extensive cash capital?

Secretary GEITHNER. Congressman, again, I am not sure that I can be responsive now. But, again, my principal concern—our principal concern has to be by making sure that financial intermediaries provide the basic economic function that Chairman Frank outlined at the beginning of the hearing. Those intermediaries, because of the leverage they take on, should hold adequate capital against risk. That is the centerpiece of our proposals. But I have heard your concerns, and would be happy to work with you to make sure we address those concerns.

Mr. COSTA. Final question, moving over to community banks which provide an important source of lending in my communities. Under the framework, you are saying that agencies also will have the ability to subject banks to additional capital requirements. That is not new, of course. How does the Administration plan to do that? You know, it has been tried in the past.

Secretary GEITHNER. Sir, to subject the largest institutions to higher capital requirements?

Mr. COSTA. No. Community banks to higher capital requirements.

Secretary GEITHNER. Again, we need to take a fresh, cold look at capital requirements across the banking industry, banks, thrifts, large and small. Because my general view is—and I think this is supported by the evidence in the crisis—that those capital requirements did not provide sufficient protection. So in addition to looking at the entire framework of capital requirements across large and small banks, we are going to hold the largest institutions to more exacting standards.

Mr. COSTA. Thank you very much. I yield the balance of my time.

Chairman PETERSON. I thank the gentleman. The gentleman from Texas, Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman. Secretary Geithner, thank you for being here this morning. I have an observation and a question. And let me get them both out, and you can use the rest of the time in your response.

You occupy one of the most important positions in this arena, and we need you speaking with the most credible voice possible in order to help lead this effort. I was startled when I heard your response to Mr. Posey, you went through a litany of things that have you turning the corner or looking like they are going to turn the corner.

Secretary GEITHNER. No. I didn't use those words.

Mr. CONAWAY. Let me finish. That is fine. But then you followed up by saying, and you pandered to us and yourself and the Administration when you said that that was due entirely to the work of the Congress and the Administration. So that is not credible with me and maybe some other folks.

The question I have, if we put this regulatory scheme in place, and none of us will get it exactly the way we want it. There will be some compromises that we will have to make. If we put that in place and business, and the rest of the world says no, thanks, we are not going to do it, as they said with climate change over the weekend. If business begins to go to active markets like Dubai and places where they are not as regulated, can you quantify for us the reduced role that America's domestic financial markets will play worldwide with the consummate loss of jobs and wealth and influence across the scheme?

Secretary GEITHNER. Congressman, I am very worried about that risk. I spent a large part of my professional life in trying to make sure we have more cooperation, more uniform standards, partly to reduce that risk. But my general view is that our system is stronger, has been stronger over time where we were prepared to take the leadership role in strengthening protections for investors and providing greater protections against systemic risk. Where we got that right in the past, it proved to be a great competitive asset to our financial institutions and our markets in the past. I think that basic philosophy should underpin what we do. But as you pointed out, because technology has made it much more easy for capital to move where standards are lowest, we have to do a much better job, as we raise standards here, in trying to bring the world with us. And you will be able to watch with us how successful we are in that. But I believe deeply in the importance of that, and you are right to underscore the importance.

Mr. CONAWAY. Well, I appreciate your recognition that there is some risk that if we don't in fact get it right, and even if we do get it right, we may have to collectively agree that that is a result that we are going to have to live with until the rest of the world can catch up.

So thanks for being here today. I yield back.

Chairman FRANK. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you. We have folks who bought derivatives last year. And they didn't just look at the capital that was available by the issuer; they said, well, this issuer is too big to fail now, maybe not; too interconnected to fail, maybe not; too well-connected to fail. And these derivative purchasers correctly realized that the taxpayer would bail them out, as it has.

Today, derivatives are being sold, and the buyers of those derivatives are looking at their counterparty and they are saying, well, there may not be enough capital there. But one additional source of capital is there may be more bailout.

Can you correct that misconception and make a clear statement now that derivatives that are sold today are not going to be the subject of bailouts for either the issuer or the purchaser, that capitalism is back?

Secretary GEITHNER. Congressman, I understand your concern and I believe I share its fundamental premise. If we are going to be successful in creating a more stable system, we have to make sure that we address and reduce the moral hazard risk produced by the interventions expressed.

Mr. SHERMAN. Mr. Secretary, even before we create a new system—I am talking about today, literally today—can you tell people who are buying derivatives today that they can't look to the taxpayer for any kind of bailout should the issuing party be unable to——

Secretary GEITHNER. Again, Congressman, let me just start with your premise. A principal source of losses to the core of the financial system came from institutions like the monolines that are relatively small institutions. Nobody thought they were too big to fail and they received no assistance from the government, writing protection well in excess of their capital requirements. So I don't think I believe in the basic premise of your question, although I share your concerns.

Mr. SHERMAN. Mr. Secretary, I am not asking for philosophy here, whether you agree with me on the premise. I am asking a very simple statement: Is it at least theoretically possible that a derivative issued today will be subject to a bailout tomorrow?

Secretary GEITHNER. Congressman, I just don't think that there is an enormously complicated set of legal conventions around the diversity of financial products in our markets, and I don't think that that question, as you phrased it, I can respond to——

Mr. SHERMAN. Let me ask the question a different way. Do you want to use this opportunity to tell the financial markets that there is no bailout or a possibility of one? Or do you want to use this opportunity to tell our constituents that derivatives being sold today might result in the bailout payments of tomorrow?

Secretary GEITHNER. Congressman, what I want to use this opportunity to do is to lay the case for why we need comprehensive oversight and regulation of the participants in the derivatives markets and those instruments.

Mr. SHERMAN. Mr. Secretary, I can understand why you prefer to answer somebody else's question, but I get 4 minutes. It is a very simple thing.

Secretary GEITHNER. You can ask it different ways if you want, but——

Mr. SHERMAN. I want a yes or no answer.

Secretary GEITHNER. No, I am not going to answer that way, because what you are asking me to do is to give an irresponsible answer to a complicated legal question. And I am not going to add to what——

Mr. SHERMAN. What you are basically saying is that you think it would be irresponsible to tell people that derivatives issued today are not possibly going to get——

Secretary GEITHNER. No, I am not prepared to answer that question that way as it was framed. But I will happy to talk to you about this at any length you would like and try to make sure we come to a better understanding about the legal complexities.

Mr. SHERMAN. I look forward to those discussions. Thank you.

Chairman FRANK. The gentleman from California, Mr. Royce, appears to be next on this list.

Mr. ROYCE. Thank you, Mr. Chairman.

And, Secretary Geithner, I would like to begin by thanking you for your work on this regulatory reform package. I think there are a number of provisions in there that I am encouraged by that are contained in the white paper. There is, however, one that raises concerns, and let me raise that with you, and that is to ask you about the resolution authority that you discussed in the white paper. This idea, as you portrayed it, is for government to unwind failed institutions. But it seems to allow for simply propping up struggling firms. It seems to be basically permanent bailout authority.

And I guess the reason I am concerned, you have the government—you have politicization of the economy as it is. We are looking at a situation where we might have a government takeover of health care, of the energy markets, the government is running GM and Chrysler. And now, you look on page 77 of the reform proposal, and this is how it reads:

"The regime also should provide for the ability to stabilize a failing institution by providing loans to the firm, purchasing assets from the firm, guaranteeing the liabilities of the firm, or making equity investments in the firm."

This sounds like the FDIC's open bank assistance authority, which provides direct funding to an operating insured bank to keep it from failing. And such authority is of course markedly different from a resolution authority that would entail an orderly unwinding of a failed institution. So you could have basically permanent bailout authority where the Federal Government continues just to keep putting taxpayer money into institutions.

Secretary GEITHNER. Congressman, if we were proposing that, what you described, you would be right to be concerned and I would not support a proposal described as you did. What we are proposing to do is to take the basic framework that the Congress legislated to allow the country to deal with risks to the financial system posed by the failure of banks and thrifts, and to adapt that framework to give us similar authority to deal with a large complex financial institution.

The absence of that framework and that authority was enormously damaging to this country. We are going to take a framework that was carefully designed by the Congress, with good checks and balances, lots of experience over time, and simply adapt that framework to give us similar tools to help manage the unwinding and the failure of large complex institutions. That is the proposal. Again, there is—the virtue of using the model we have, which is the FDIC resolution framework, is that that has been tested, people understand its merits and complexity, and gives us a little bit better basis for finding consensus on the right approach.

Mr. ROYCE. But, of course, given recent actions and given the fact that this is worded in a way that it does not require an unwinding process. Given the fact that based on current action we are left with the assumption that this certainly would allow, the way it is written, ongoing government involvement in a way which would continue to put taxpayer funds into an entity without limit. And let me ask you another question.

Secretary GEITHNER. I don't think it has that risk, Congressman, again, because the centerpiece of our reform proposals are to create a system that is strong enough to withstand the failure of major institutions. But to do that effectively, we need authority Congress gave——

Mr. ROYCE. Let me ask my last question. You were at the table for many of the discussions to either provide a lifeline or to let an institution fail. These were very difficult decisions at a critical time. If I could ask you to commit your staff to provide for the record a detailed analysis, walking us through how this authority would have changed the way in which AIG or Lehman Brothers were handled, and exactly how the counterparties of these firms would have been treated differently under this regime.

Secretary GEITHNER. Hard to do, but I will be happy to try to do that well. And I am sure I will have the opportunity to testify before the Financial Services Committee on the broad range of——

Mr. ROYCE. I would appreciate it, Mr. Secretary.

Chairman PETERSON. I thank the gentleman. The gentleman from Georgia, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman.

I suppose, had you chosen to answer Mr. Sherman's question, you might have said that the United States is going to stand behind its money supply. We are going to design our regulations to assure that there is no necessity for the government to intervene and prop up the money supply in the future. And, it would be very foolish for anybody investing now to even vaguely think that it is likely that we will fail to do that. But in the event that we fail, the world can rely upon the American money supply. We will take the actions necessary to protect the money supply.

Mr. Sherman and I just had a difference of opinion concerning whether or not TARP was an ill-advised move. I thought it was, he thought it wasn't. I thought it was dreadful that we had to do this and a real failure by leadership in this country across a broad range. But it was something that I thought we needed to do. And I would be shocked if we wouldn't do something similar in the future if it was necessary, but also shocked if we don't take the kind of action that is necessary to assure that it is not necessary in the future.

Mr. Secretary, you have in your written testimony the reference to we were going to require this, require this, require that, *et cetera*.

Secretary GEITHNER. Proposed to require.

Mr. MARSHALL. Well, we also will require, is the way you put it. I think there are good things to require. The devil is in the details of course. We will work those details out. But the specter we have is we don't want to disadvantage American business, we don't want to disadvantage the American financial industry. And you also referred to: "Finally, we will continue to work with our international counterparts to assure that our strict and comprehensive regulatory regime for OTC derivatives is matched by a similarly effective regime in other countries."

Chairman Peterson led a CODEL to Europe. We talked with other countries about this very question, regulatory arbitrage country-to-country. It has been a challenge for us. I have no real confidence that you are going to be able to line up all of the countries; that some country won't decide to not adopt the strict requirements that we think are advisable in order to have a competitive advantage, in order to have that country become a financial center. Hence, things like the Cayman Islands, *et cetera*, pop up. I think it just denies history to suggest that there won't be countries like that.

Has any thought been given to the United States perhaps teaming up with Europe and coming up with a fundamental regulatory scheme, sort of minimum standards that are acceptable. And then simply announce that investors will not be permitted in any way, directly or indirectly, we are going to look at substance, not the form, to be in our markets if they are elsewhere playing in markets that are not living up to this minimum regulatory standard? Because it just seems to me unrealistic to think that we are going to be able to do much more than that. So if there has been thought given to it, could you share that with us?

Secretary GEITHNER. I am not sure I would go quite that far. I think our basic approach is very similarly laid out. And there is an elaborate cooperative framework now in place that has the United

States at the table with, not just Europe, but the other major financial centers to design minimum standards, and make sure they are more evenly enforced. I am not sure we can go quite as far as you suggested. But the basic philosophy you laid out——

Mr. MARSHALL. Mr. Secretary, is it your impression that all of these countries are going to agree with the different things that you are suggesting we should require?

Secretary GEITHNER. I completely agree with you that it is going to be enormously difficult, but it is the right thing to try to attempt.

Mr. MARSHALL. Mr. Secretary, if we move forward and require these things, are we going to be disadvantaged?

Secretary GEITHNER. I think that if we get the balance wrong and do it poorly, we will face that risk. But we are going to try to be careful to do it in a way that improves confidence in our markets, in a way that reinforces what has been substantial assets for this country, which typically had stronger standards than those that were applied around the world. But, again, this crisis has been so searing for countries, not just in Europe, but across the world, there is going to be substantial interest in raising standards there, too.

Mr. MARSHALL. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Chairman FRANK. Chairman Peterson and I have discussed this. It will be our intention to include in legislation strict instructions to all the American financial regulators to apply the strictest possible sanctions to any outlying country like that. I would agree, with the EU, with Japan. And we have had a lot of conversations. But I believe that we should then say that any country that allows itself to be the host to that loses access to the American banking system, *et cetera*. And I believe we will have very strict instructions in there that is at least a substantial protection. The gentleman is absolutely right.

Chairman PETERSON. The gentleman from Louisiana, Mr. Cassidy.

Mr. CASSIDY. Mr. Secretary, you know far more about this than I. I am not challenging you, rather just posing these for thoughts. Natural gas, that would be currently OTC. And public utilities sometimes, I am told, put up their physical assets as collateral, and it is a straightforward swap without an additional fee imposed by the exchange.

Now, I understand speculators are, well, speculators, they either drive up costs or manipulate the market allegedly, but also provide liquidity. And so my question is, though, if we require these public utilities to go through an exchange, perhaps put up cash, disrupting their cash flow, certainly potentially paying a fee, it seems like we are going to pass on higher costs to consumers from entities which are really not out there to disrupt the market, but rather hedging future costs.

Is there a way that we can carve out these entities from the central clearing, for example, as one solution, or some other way to mitigate the increased costs that will be passed on to consumers?

Secretary GEITHNER. Congressman, again, I think this is going to be an important issue. I believe that the experience with central clearing where it has existed, and the experience with the migration of derivatives onto exchanges has generally reduced costs to users. I think that is encouraging. But as we have said many times, we are still going to preserve the capacity for a range of companies throughout and across the country to engage in on a bilateral basis customized hedges outside the standardized clearing area. We just want that to at least come up with some protections.

Mr. CASSIDY. You were saying that, and you have given good testimony. It seems, though, that, my gosh, public utilities would not be customized; rather, it seems like that that would be——

Secretary GEITHNER. In fact, I have received a lot of letters, and I suspect many of you have, from utilities saying that we want to preserve the capacity to engage in, embark in more customized sets of hedges, and we want to preserve that capacity. But, again, we want the system to be protected against the risks those things present, so there needs to be broader oversight for the SEC and the CFTC over those activities. But I don't think we are in a different place, and are very sensitive to the concern you laid out.

Mr. CASSIDY. So just to follow up, because I do think we are close to a similar place. Your definition of something that would be standardized, I think, was high volume. So I was, if you will, gathering from that that almost by definition these contracts would be considered standardized. But even if they are high volume, they still may go into a customized category.

Secretary GEITHNER. I think the question is, are the terms common and more typically uniform? Or, do you need a—can you not meet your individual needs to hedge against the risk you face with those commonly prevailing terms. I think that is the way to think about the definition. But, again, this is a complicated thing to get right, and we are going to do our best to make proposals to you to get the balance in the right place.

Mr. CASSIDY. And just to follow up one more aspect of my question quickly. Again, I am told that sometimes the utilities will put up their physical assets as collateral as opposed to cash. Will that be part of this kind of balance?

Secretary GEITHNER. That is something I have to think about and get back to you on. I don't think I can do justice to the details of what market practice is in that area today. But I will be happy to try to get back to you on that particular question. Several of your colleagues have raised it.

Mr. CASSIDY. Thank you very much. I yield back.

Chairman PETERSON. I thank the gentleman. And I would just like to comment that there has been a lot of talk about these customized *versus* standardized. What people need to understand is that these banks make a lot more money on customized trades than they do on standardized. So keep that in mind.

Secretary GEITHNER. Mr. Chairman, could I just say something in response to what you just said on that question? I think you are right, and that is why I think that as you go through this process you want to make sure you are not listening just to New York and Chicago. You want to make sure that you are listening to the range of companies that rely on these markets as their risks. I think here there really is an interesting diversity of opinion. But what we are proposing is to make sure that where there is a good compelling case for the customized, that it comes with protections so that the system is not vulnerable to the risks those present.

Chairman FRANK. That recalls to me my own distinction between ends and means. We are talking about the end-user, not the people who make money on the instruments, *per se.*

The gentleman from Kansas, Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

Mr. Secretary, many Americans probably never heard of derivatives before the financial meltdown, although many companies in the United States used derivatives to manage and hedge their risks. It appears there are two sides of risk from looking at how best to oversee the OTC derivatives market. On the one hand there is the risk to the financial system if they are left unregulated, and on the other hand there is the beneficial tool of risk management that derivatives can provide to many businesses, large and small.

Mr. Secretary, I believe we need to regulate this part of the system that was ignored for too long, but we should be careful of unintended consequences.

When we consider the United States companies that played no role or part in the financial crisis, how should we weigh systemic stability against higher requirements for firms that are end-users of derivatives? Is there a chance systemic risk could actually grow if companies are forced to stop hedging the risks that they have on their books?

Secretary GEITHNER. Yes. I do believe that if you deprive institutions of the capacity to manage their risks effectively, you could create a less stable system.

Mr. MOORE. Some claim that the Administration's plan will cost hundreds of billions of dollars that companies would have to post to a clearinghouse. Have you done any cost analysis of the effects on these companies?

Secretary GEITHNER. It is a hard thing to do well. But, again, it is about the balance. The benefits to the system of having more conservative margin requirements than we had coming into this crisis are going to be very, very substantial economically. But you don't want to have them to be so high that you push a bunch of risk offshore or to other places. And that is going to be a hard thing to get right. But I don't think you can look at the last couple years of history and say that we erred on the side of having to be too conservative.

Mr. MOORE. Thank you, Mr. Secretary. I yield back.

Chairman FRANK. The gentlewoman from Illinois, Mrs. Biggert.

Mrs. BIGGERT. Thank you, Mr. Chairman. And thank you, Mr. Secretary, for being here.

The Administration's proposal strips all of the consumer protection functions from all the banking regulators and puts them in a separate agency, to me essentially making the government bigger but not better for consumers. Won't your proposal deny the regulators the ability to manage the risk of a financial institution, and won't these new agencies tell consumers what they can and cannot have, and tells business what products they can and cannot offer conflict with the safety and soundness role of the banking regulators? Can you give me a yes or no answer?

Secretary GEITHNER. No. But maybe I could—could I say a few more things in response? We are not making government bigger in this case. As you said, we are taking authority that exists in a bunch of different places, both rule writing and enforcement authority, and we are moving that to a central place where there will be more accountability and, we hope, better outcomes than we achieved with the system that we have been living with.

Mrs. BIGGERT. Well, then what is the function of the banking regulators, the safety and soundness?

Secretary GEITHNER. Principally, safety and soundness. But as you and I have discussed in the past, there are areas where these things overlap. So it is not going to be a completely bright line. But we want bank regulators to be principally responsible for safety and soundness, and we think we are going to have both better consumer protection and better safety and soundness regulation if we have better separate accountability for those functions.

Mrs. BIGGERT. Do you see then the Consumer Financial Protection Agency trumping the existing regulators?

Secretary GEITHNER. Again, we are proposing, to give them rule writing authority and primary enforcement authority over consumer protection, not over safety and soundness.

Mrs. BIGGERT. It seems like there will be a lot of duplication of effort.

Secretary GEITHNER. We want to avoid that, but again there is a lot of duplication of effort in our system. Our system is characterized by a, frankly, difficult to defend mix of parts of the system with incredible overlapping authority and parts of the system where nobody had good authority. So it is not a system we would have designed if we were starting from scratch today. We are going to try to get clearer accountability, more focused accountability, less overlap but better safeguards where they didn't exist.

Mrs. BIGGERT. How do you do that if you separate those?

Secretary GEITHNER. Well, they are very different types of functions. They have not been done particularly well when they were done as they have been done to date. What we argue here is separating is more simple and clearer.

Mrs. BIGGERT. I have concerns about the recently passed cap-and-trade bill, and it had—about derivatives in there, and language is included to regulate the OTC markets and limit participation in the markets. I would like to know, what is the Administration's position on the bill's new tax on transactions? And I know that there was a caveat in the 3 a.m., 300 page manager's amendment which put in a caveat that if there is legislation passed this would be null and void. But what did you think about what was in that bill? And will some of that carry over into other legislation?

Secretary GEITHNER. Congresswoman, for reasons that I think you can appreciate, can I respond to that in writing——

Mrs. BIGGERT. I would appreciate it.

Secretary GEITHNER.—or separately in some appropriate form? It is a complicated bill that has a lot of complicated provisions in these areas, and I want to do it well.

Mrs. BIGGERT. Just one quick question. I am still worried that we are going to incentivize much of the market to move overseas if we impose new regulations on the market, the over-the-counter market. How could we really forestall that?

Secretary GEITHNER. Well, it is an important thing to avoid. But if you look carefully at what the Europeans are proposing now, what the U.K. has proposed in public now, there is much more convergence in our approach than we have seen in a long period of time, and that is encouraging. But we share your commitment to that and want to be careful to avoid that risk.

Mrs. BIGGERT. Thank you. I yield back.

Chairman PETERSON. The gentleman from Indiana, Mr. Ellsworth.

Mr. ELLSWORTH. Thank you, Mr. Chairman.

Secretary Geithner, we have all got hundreds of questions we could ask you, and luckily for you we have only got 4 minutes to do it. I would like to go back in time, since this is our first meeting, back in time a little bit.

The first time I heard about a credit default swap was, I think it was, in a *TIME* magazine article maybe 7 months ago, something like that. I thought it was just me living under a rock until I started polling people back home, and most people have not heard of that term.

Can you tell me, for my reference and my education, how we got there? If this was a life insurance company that was selling policies that they had no capital or were undercapitalized they would be in jail. Bernie Madoff has now been sentenced to what is essentially life in prison for a Ponzi scheme. Can you give me some background to how we got there and how we are going to prevent that in the future? And if you can throw in what, if we know the dollar figure on what these credit default swaps are worth. I have heard trillions. If you can tie that even to a broad range, I would appreciate it, sir.

Secretary GEITHNER. I would be happy to respond. The overall estimates of magnitude of the total face value of these markets are in the $600 trillion range. The market value of those contracts, my testimony, says are more in the $20 trillion range. That still itself doesn't really capture the risk. It probably substantially overstates it. But these are enormously large markets, enormously important to how our markets function. These markets include interest rate risk, exchange risk, equity derivatives, commodity derivatives, energy, food, *et cetera*.

And the way this happened in credit derivatives was very similar to what happened in commodity derivatives and others, which is that decades ago people figured out a way to offer a company the ability to hedge against a particular risk, the cost of energy, cost of seeds, cost of movement in exchange rates, cost of a change in interest rates, and over time products emerged to meet that economic demand.

What we did not do in our country is stay abreast of that innovation and put in place the framework of protections over those markets that was commensurate with the risk they proposed. We were behind that curve. And we had a lot of institutions, including regulated institutions like the monoline insurance companies and AIG that wrote a huge amount of protections without the capital to back it, and that combination of factors helped bring us to the edge of this very severe crisis. And it is an obligation we all share to make sure that we not just address those principal causes of this crisis, but we have a stronger framework to address future vulnerabilities, and that our framework adapts more quickly in the future. And that is what we are trying to do.

Mr. ELLSWORTH. What would be the consequences—whether we voted for the bailout, the TARP, any of that. What would be the consequences if these were called in, these credit policies? Could they be called in, cashed in, make due on the credit default swaps?

Secretary GEITHNER. I wouldn't think about the economic risks in what the Congress authorized for the financial sector as being principally affected by what happens in these derivative markets. The principal risk, the economy, as many of your colleagues have said, is we are living still with a very challenging set of economic risks in the future. But if we are successful working together, putting in place a stronger foundation for recovery, then the ultimate risk to the taxpayer, the things we want to do, will be lower.

Mr. ELLSWORTH. I will yield back.

Chairman PETERSON. The gentleman from Pennsylvania, Mr. Thompson.

Mr. THOMPSON. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for being here, for answering these questions. With your proposal, I wanted to just seek some clarification.

Is it your intent to force private commodity pool operators to register with the SEC as a hedge fund instead of the CFTC? And, if so, why?

Secretary GEITHNER. I haven't quite come to a firm conviction on that question, but we are working through it with the SEC and the CFTC. What we have been explicit about is that we want to make sure the hedge funds above a certain size are compelled to register. But you raise a very important question, thinking about how we treat other entities that are doing similar things, and there are a bunch of entities in those markets that are already forced to register, and we will have to think through carefully the implications of doing what we propose on hedge funds. We are not quite there yet, though.

Mr. THOMPSON. Your proposal talks about harmonizing the SEC and CFTC. Your opening remarks talked about, or more earlier responses talked about statutes, both need to be brought in line. And I wanted to just see, where is that harmonization needed and where is it possible?

Secretary GEITHNER. Well, we hope it is possible generally across the board because you have these two differences. You have different basic statutes across the markets they are responsible for, and you have different enforcement cultures and enforcement approaches. And those two differences themselves create a system that is not as good and strong as we think we can have. So what we are trying to do is get the SEC to bring them together and get them to propose ways to bring those into conformance. And they are making some progress, but they have a long way to go. But we are going to want to spend a lot of time working through the detailed merits, alternatives, of different approaches in those areas. But we are not far enough along yet to go into any detail today.

Mr. THOMPSON. Thank you, Mr. Secretary. I yield back.

Chairman FRANK. The gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. We had a chance to chat about this a little earlier in the week. But I want to go back to the system that the President's plan envisions, where you have standard derivatives traded over an exchange, standard ones being linear in many cases, well understood. And yet you have another system right beside that parallel system for custom derivatives trading privately with far less transparency. There are a number of moral hazards here, and I want to have you address them.

Number one, as the Chairman pointed out earlier, there is a big payday for the banks and for the derivative designers on the custom side of the house, much more so than on the standards side.

Second, experience has shown us whenever you have a regulated system operating beside an unregulated system, the markets favor that unregulated system and the money migrates over.

Third, the absence of an exchange by—the exchange serves a purpose as a pricing mechanism, and a major problem with these derivatives has been the accurate pricing of risk. And so you are putting these custom derivatives off the exchange where there will be, again, a mispricing of risk that will continue.

And, last, we are still allowing these gratuitous side bets where folks can come in and take a bet where they have no interest at all in the underlying asset. And those are all moral hazards that are going to lead us to continue to have a system that has gaping holes in it. And I just don't know how I can support such a system.

Secretary GEITHNER. Congressman, I thank you for giving me another chance to respond to that concern. We are proposing comprehensive oversight, but we are not just overseeing the participants in these markets but over all the products, standardized or customized. We are proposing to give the SEC and CFTC the authority they do not now have to enforce fraud activities effectively in those key markets, whether standardized or customized. And like you would expect us to do everywhere, we are trying to make sure that the capital requirements and margins are higher where risk is higher. And that will help.

Mr. LYNCH. But, sir, could I ask you about the pricing mechanism? Where there is no exchange, you have these custom derivatives being sold by private parties.

Secretary GEITHNER. But you are exactly right that you want to have the standardized parts where you can have price discovery and competition. The terms are standardized traded on exchanges or on, as we said, open, transparent, electronic trading platforms because of the benefits of price discovery. But a customized unique special hedge that a utility that provides energy needs, that is going to have to be a negotiated product by definition. Because if they can't meet the needs through the standardized product, they need to have the capacity to go in that direction.

Now, you are in effect suggesting, as some have suggested, that we force all of this stuff onto exchanges effectively banning the capacity to the customized. And I would just would caution you to listen carefully to the users of these markets because you will find, as I am sure you are aware, companies in industries across the country, small and large, trying to make sure that we preserve that capacity.

So we are going to try to get that balance right where there are the concerns you said. I think we proposed a substantially better balance then we have today.

Chairman FRANK. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Secretary, I am going to paraphrase part of your testimony. You essentially said, I believe, we are here because the Administration inherited an economic mess. I don't necessarily disagree with that assessment. I would say the question is whether or not the Administration's policies are making this mess better or worse.

Since the Administration has come to office, clearly you know that unemployment has risen to 9.5 percent, the highest in a quarter century: 2.6 million additional jobs have been lost since the Administration has taken office. The public debt has increased by almost $1 trillion or $7,430 per household.

Given that backdrop, I am having to look at this new proposal that you bring before us today. In the Capital Markets Subcommittee last month the 3M Company testified that they projected that they would be looking at $100 million per year on average in additional costs for a mandatory clearing environment.

Now, I believe in questions by the gentleman from Kansas, Mr. Moore, I believe you said something along the lines of: It is very difficult to ultimately gauge the cost burden for those who may have to go to a mandatory clearing.

Secretary GEITHNER. But I also said that typically the costs of central clearing exchange are substantially lower.

Mr. HENSARLING. I would ask this question, Mr. Secretary, given this is just one corporation, but I have heard this from other corporate entities as well. And listen, I am not unsympathetic that improvements can be made in clearing these derivatives, particularly with respect to transparency, with respect to margins. But I am very concerned about a proposal that at least, as of today, seems like we are trying to still pin the proverbial Jell-O on the wall. If we don't ultimately know the cost, we do know this: Less hedging can create less credit, and less credit can create fewer jobs. And in this economy, I am just very leery until I have convincing evidence about the ultimate cost and the ultimate impact on our job environment for moving forward on this.

And so I guess the question would be, when will the Administration do modeling on jobs? When do we expect that analysis?

Secretary GEITHNER. Congressman, as you know, you and I are going to disagree very fundamentally on where you began your question, which is the appropriate response of a country facing a crisis like we inherited. But on the question you are raising, which is about the benefits of hedging and how we get the balance right between stability, innovation, and the future, I suspect that our differences are much narrower, again, because, as I have said many times here today, we trying to preserve the capacity for hedging. We are trying to make it better, more possible for our country to have both a more stable, more resilient system, and preserve the capacity of people that hedge against these risks. We are basically committed to that. We are trying to make sure that innovation, which is a great strength of our financial system, can proceed in the future with less risk of catastrophic damage. But I suspect that we don't—our differences are not as great. They are probably very great where you began your question. And I would be happy to talk about that at any time.

Mr. HENSARLING. I hope that proves true, Mr. Secretary. Sometimes I find myself agreeing with 80 percent of the Administration's rhetoric and about 20 percent of their policies.

The next question, Mr. Secretary, in your opening statement——

Secretary GEITHNER. I am happy to consider alternative recommendations and policies all the time.

Mr. HENSARLING. I don't mean to put words in your mouth, but I now have 30 seconds. I think you said again that some of your critics you said were wanting to maintain the *status quo*. Many economists believe that the greatest cause that we have for the economic crisis was Fannie and Freddie, and yet your reform proposal does nothing about Fannie and Freddie.

Secretary GEITHNER. I am very glad you raised that. It is absolutely true that those institutions over time took on enormous risk because of the implicit commitment of the government to back them. And that is why Congress legislated a reform framework over those entities last year, but that came unfortunately late in the process.

Now, we are going to have to come to the Congress and propose how to deal with the future of those entities. But now is not the time to do that. And we are going to try and do that carefully and well. But we agree with you that that is something we are going to have to confront together, and we will come to you. It is our responsibility to do that with our best judgment about what to do, but we will look at a range of options and we will work through that together.

Mr. HENSARLING. Thank you.

Chairman PETERSON. I thank the gentleman. The gentleman from New York, Mr. Murphy.

Mr. MURPHY. Mr. Secretary, I want to say thanks for all your hard work on this, and I know that you have been pushing for clearing of credit default swaps long before any of us ever heard about it. I know you were out there and wish that we had been able to get that done earlier than we are now. I have a couple nuanced questions. I missed some of the testimony and you may have answered this already.

In your testimony, you talk a lot about clearinghouses and clearing stuff, putting it on exchanges. Do you see those as one-to-one, or is there some transactions that might be cleared and not on an exchange, or *vice versa?*

Secretary GEITHNER. Absolutely. There are some things that can't be cleared and, therefore, can't be put on-exchange. And you can have some products that can be essentially cleared that don't need to clear on the exchange. But, yes, the answer is that there are some products that, to meet a demand for a particular utility to hedge a particular energy cost, you probably can't centrally clear. A clearinghouse wouldn't want to take on that product, wouldn't think that they could manage that risk.

Mr. MURPHY. Well, I don't want to discourage you from products that we may be able to drive to central clearing, because I think that does reduce systemic risk, that we not require be on an exchange if there is not enough volume for an exchange to want it, or for there to be any real price discovery there.

Secretary GEITHNER. You are right to emphasize that. We have been very clear to say we want to encourage standardized to be centrally cleared. In fact, we are going to compel that. And, we would like to see those products that are centralized ending up traded either on exchanges or on electronic transparent trading platforms, because of the benefits you get to price discovery and liquidity in that method.

Mr. MURPHY. The second point: Would considering putting minimum requirements from margins for the clearinghouses?

Secretary GEITHNER. For the clearinghouses, absolutely. I think one of the important things, because they concentrate risk, you need to make sure that there are adequate margin safeguards against the risk of default.

Mr. MURPHY. I want to be confident. I think competition is good, but I want to be sure we don't have a race to the bottom where people shop for the cheapest clearinghouse.

Secretary GEITHNER. You are absolutely right.

Mr. MURPHY. The last question, hedge accounting. I hear from a lot of the companies I talk to that hedge accounting, to be specific enough to get the treatment they want, requires them into a customized OTC marketplace, kind of going against what we are trying to do.

How can we address that to try to bring that together, where people who truly are hedging aren't pushed to do something that takes them off of a standard, or exchange traded, or cleared product?

Secretary GEITHNER. You are absolutely right. The part of the concern businesses have with banning customized products is they are concerned that the accounting requirements—they would not be able to meet those basic requirements. And that is one important concern. But, the more fundamental concern is, again, that not all risks that people have an interest in trying to protect themselves against can be adequately captured by a standardized instrument.

Mr. MURPHY. I agree. But I guess the question is how do we, for the risk that probably shouldn't be in the OTC market, not let our accounting rules drive us into that? I guess I want you guys as you are working on this, and for us to keep in mind, that we should try to harmonize that so we don't drive stuff into the OTC market that doesn't need to be there.

Secretary GEITHNER. Yes, I think that is a good thing to take a look at. And of course we have an elaborate protection independent of political influences, trying to think through the accounting standards, and—but I agree with you that is important to look at.

Generally, we have a problem where a lot of accounting stuff runs against the basic interests of—well, I want to be more careful in how I say that. I think you are right to try to point out the importance of that.

Mr. MURPHY. I think it is an important part of getting this all right. We can try to push it in one direction, but if we get into the accounting rules where we are marking one side of the balance sheet to market and not the other, or we are driving them to do something that moves them out of what is the most stable financial system, those rules can actually have a big impact on what people decide to do over here.

I yield back my time.

Chairman PETERSON. I thank the gentleman. The gentleman from Missouri, Mr. Luetkemeyer.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Secretary Geithner, welcome. I am just curious about the final comment in your statement today or your suggestions in your statement today was about working with our international counterparts to ensure strict and comprehensive regulatory regime in our over-the-counter derivatives. And I know we addressed it a couple times here and got around some of the edges of it. Could you just discuss that for a few minutes as to the size of the involvement of our foreign counterparts. If you have had any negotiations with those folks at this point; where do you see the problems, or where you see the positives of where we need to go with this?

Secretary GEITHNER. Let me give you one example to show you how important this is and how you can do it and do it well.

Starting in 2004, 2005, the New York Fed brought together the supervisors responsible for these markets, and for all the major derivatives dealers responsible for 95 percent of trading activities in these markets, around one table and compelled them to agree to a set of measurable benchmarks for improving standardization, automation, basic risk management, quality of infrastructure in these core markets, because they were global markets. And so that is one way to do it.

Mr. LUETKEMEYER. How did you compel them to do that?

Secretary GEITHNER. Well, what we did is by getting the supervisors to agree on a common framework of constraints and reporting standards. We made it possible for each of those institutions that exist in different countries, different jurisdictions to be held to common standards. And we tried to enforce it not through just supervision, but make sure there was transparent reporting of performance across firms. And that helped make sure there was a level playing field. That is just one example.

The U.S. has been terrifically effective in the past in the capital area decades ago in trying to get the world to come to our higher standards, but we didn't—we are not effective enough. But we are going to be very focused, as I said, in trying to make sure we bring the world together around a table to do it. We have a very elaborate set of cooperative mechanisms in place today working alongside the legislative process here.

Mr. LUETKEMEYER. How much participation do we have from other countries *versus* the amount of participation within our own country? Do you have a percentage roughly on something like that?

Secretary GEITHNER. You mean in terms of where market share in these things are?

Mr. LUETKEMEYER. Yes.

Secretary GEITHNER. I believe that—it varies a lot across products, but I would say it is probably on average roughly 50/50 U.S. and Europe. But don't hold me to that. I would be happy to——

Mr. LUETKEMEYER. Well, that gives us an idea of the importance of the issues.

Secretary GEITHNER. I agree with you.

Mr. LUETKEMEYER. Do you have some things that are some problems right now with the way other countries are regulating their securities markets that we need to be concerned about and we need to watch for?

Secretary GEITHNER. Well, there is a—one concern I have, is that these are global markets and you want to have a common global framework, and there is a tendency in Europe to try to come up with a European solution to managing risk in these areas. And we had been very successful in the past in working with Europe to come up with a common approach, because we think that will be more effective in reducing risk.

And that is one example where, frankly, I am a little concerned, that they want to come up with a separate approach. And so we are going to try to work with them to make sure that we end up with a thing that works for these markets and is reducing overall risk.

Mr. LUETKEMEYER. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman FRANK. I have a proposal. We have a vote. There are three Members left on the Democratic side. I am wondering if Members could each do a minute and a half, pose a question and have the Secretary respond. Would that be acceptable.

The gentleman from North Carolina, gentleman from Texas, gentleman from Illinois. Maybe we can shave it a little bit down to 1½ or 2 minutes for questions.

Mr. MILLER OF NORTH CAROLINA. Good morning, Mr. Secretary—or, good afternoon, Mr. Secretary.

Most of what you have discussed, justifying derivatives—the purpose of derivatives is they are risk mitigation. They are like insurance. But it appears that there is no requirement with respect to derivatives that any party of the transaction actually have an interest in the underlying asset, the asset from which the derivative is derived.

Obviously, if there is no risk to mitigate, it can't be risk mitigation. It doesn't appear to have anything to do with capital allocation. The only justification I have heard is it assists price discovery, and that the more transactions are based upon the value of an asset, the more accurate the price is. But that seems pretty thin given how huge the derivatives market is.

Did you give any consideration to whether or not these products should be allowed at all, if they do anything useful for society? Do you think they——

Chairman FRANK. The gentleman from—well, let's get the question. The gentleman from Texas, do you have a question, a quick question?

Mr. GREEN. I am sorry?

Chairman FRANK. Does the gentleman from Texas want to ask a question? We will try and get all the answers.

Mr. GREEN. Yes, sir.

Chairman FRANK. Well, please ask your question, quickly, if you will. That is what I had announced.

Mr. GREEN. Thank you, Mr. Secretary. I will get right to it.

We have 8,246 depository institutions in this country. We require that they be well-capitalized. We have a coffer within which they pay an assessment, so as to provide the capital to wind them down when they go out of business.

Is it true that what you plan to do is provide a similar circumstance for nondepository institutions such that, when they become troubled, we can wind them down, they are not to be over-leveraged, they can engage in hedging without being over-leveraged, such that we can wind them down in a similar fashion?

Secretary GEITHNER. Yes.

Chairman FRANK. All right. Ms. Bean, and then we will see if we can get an answer. We will have one last questioner.

Ms. Bean?

Ms. BEAN. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for being here today.

To pick one question, there have been concerns raised about mandating clearinghouses to clear illiquid derivatives could force untenable risk levels onto the clearinghouses from the derivatives markets. How would you or your proposal address that concern?

Secretary GEITHNER. Can I go in reverse order? Well, I will go in a different order. I said yes to you——

Chairman FRANK. Go.

Secretary GEITHNER. Okay. You need to make sure that there are margin requirements and financial safeguards in the central counterparties that are adequate to compensate for that dramatic concentration of risk. That is the way to do it; you want to make sure it is uniform across those.

You will have a chance to listen to businesses across the country speak to your question, which is, is there economic value in my capacity to take advantage of a derivative to hedge against a risk? And, again, our judgment is, yes, there is, but the system has to have greater protections around that.

But the existence of an underlying asset is not a good measure about whether there is an economic value in the ability to hedge. But this is a complicated question. I would be happy to talk to you in more detail in another context.

Chairman FRANK. The gentleman from New York, Mr. Lee, is our last questioner.

Mr. LEE. I will shift gears here since I am sure you are a little tired of discussing this. But this is an issue that is near and dear to my heart and dozens of my colleagues on both sides of the aisle, and it has to do with the Delphi retirees. And hopefully you are familiar with this with the auto task force, and the fact that you have, really, two groups here being treated completely differently in terms of their pension responsibilities.

The hourly workers got 100 percent coverage while the salaried workers stand to lose potentially up to 70 percent of their pension. In this past year, all of these salaried retirees have lost their health care benefits and their life insurance.

Being the fact that we now, in the government, own 60 percent of General Motors, I have been trying to reach out to your organization, the auto task force, and trying to get some answers for these retirees who are extremely frustrated. And I would like your thoughts on this inequity and what we can do about it.

Secretary GEITHNER. Congressman, there are an enormously complicated set of tradeoffs in the judgments that have had to be made as part of this restructuring process. And I would be happy to have our team come meet with you and talk you through why the judgments that have been made have been made and why the alternatives were not tenable. I would be happy to do that.

Mr. LEE. Well, I would like to hopefully come up with a solution. But, yes, I would appreciate having that opportunity. So thank you.

Chairman PETERSON. I thank the gentleman.

The gentleman from Oklahoma has a question.

Mr. LUCAS. Mr. Chairman, I would like to add a letter from 3M on behalf of one of my colleagues, Mrs. Bachmann, and another letter from the National Business Roundtable and a number of other groups.

Chairman PETERSON. Without objection.

[The document referred to is located on p. 59, and the prepared statement of Mrs. Bachmann is located on p. 7.]

Chairman FRANK. Mr. Peterson, I would just ask general leave for any of the Members to include any materials that they want.

Chairman PETERSON. Without objection.

Chairman PETERSON. With that, we will bring this to a close. I want to thank Chairman Frank and all the Members of both Committees for a great hearing, good questions, good dialogue. And we look forward to working with the two Committees together, along with the Administration, to make this thing work. So thank you all.

Thank you, Mr. Secretary.

The Committees are adjourned.

[Whereupon, at 1:07 p.m., the Committees were adjourned.]

[Material submitted for inclusion in the record follows:]

JOINT SUBMITTED LETTER BY HON. FRANK D. LUCAS; ON BEHALF OF BUSINESS ROUNDTABLE; GROCERY MANUFACTURERS ASSOCIATION; NATIONAL ASSOCIATION OF MANUFACTURERS; U.S. CHAMBER OF COMMERCE

Hon. BARNEY FRANK,
Chairman,
Committee on Financial Services;

Hon. SPENCER BACHUS,
Ranking Minority Member,
Committee on Financial Services;

Hon. COLLIN C. PETERSON,
Chairman,
Committee on Agriculture,
Washington, D.C.

Hon. FRANK D. LUCAS,
Ranking Minority Member,
Committee on Agriculture,
Washington, D.C.

Dear Chairmen Frank and Peterson and Ranking Members Bachus and Lucas:

Businesses from diverse sectors and sizes across the United States enter into over-the-counter ("OTC") derivative transactions to manage risks associated with their business operations, including fluctuations in interest rates, currency exchange rates and commodity prices. A survey of publicly-available information conducted by the International Swaps and Derivatives Association found that more than 90 percent of Fortune 500 companies use OTC derivatives. It is critical to note that many of our members use them—not to speculate or augment short-term profits—but as a normal course of business.

Many OTC derivatives contracts are bought and sold with standard terms and conditions; however, there are also many derivatives contracts that are customized to meet the unique needs and risk exposures of individual companies, including such basic terms as dates, rates and notional amount. When businesses employ derivatives in this manner, they are not taking speculative positions. Quite the opposite; they are seeking to *reduce* risks that arise from their business activities. Whether standard or custom, OTC derivatives help American businesses protect themselves from risk and improve their access to credit.

We support efforts to ensure appropriate regulatory oversight of market participants and their derivatives activities, consistent with the objectives outlined by the Obama Administration in its white paper, *Financial Regulatory Reform: A New Foundation.* More specifically, we believe the right approach encourages central clearing for standardized contracts where appropriate, while promoting transparency of customized contracts through a reporting regime that ensures regulators have the information necessary to oversee the markets. This approach strikes the right balance: it reduces counterparty risk and enhances transparency while maintaining an OTC market and the benefits it provides to our members.

However, legislation requiring that *all* contracts be traded on exchanges or be centrally cleared will prevent companies from using non-standard products to reduce the volatility of their financial statements and lower their cost of capital—thereby expanding, not reducing, risk to companies. Such legislation would require companies to divert cash from being used to sustain and grow their businesses to meeting collateral and margin requirements. In short, the proposal could dramatically expand the need for liquidity in the midst of a liquidity crisis.

The customized terms and conditions of OTC derivatives contracts cannot reasonably be standardized for exchange trading or mandatory clearing. In fact, in order for companies to utilize hedge accounting under FAS 133, and thus reflect the offsetting nature of a hedge in their financial statements, they must prove a close and consistent correlation between the derivative and the underlying asset or liability. If a company could not do so, as likely would be the case if only standardized instruments were available, the benefits of its hedge transactions would not be shown in its financial statements, thereby increasing earnings volatility.

In short, please ensure that any regulatory reform legislation that moves in the House preserves the ability of our member companies to use OTC derivatives to manage risk at prices and under terms that are reasonable and continue to make sense from a business perspective. We urge you to prevent an anti-derivatives sentiment from translating into anti-business legislation.

Thank you for your consideration of our views and we look forward to working with you.

Sincerely,

LARRY D. BURTON,
Executive Director,
Business Roundtable;

MARY C. SOPHOS,
Senior Vice President and Chief Government Affairs Officer,
Grocery Manufacturers Association;

DOROTHY COLEMAN,
Vice President, Tax and Domestic Economic Policy,
National Association of Manufacturers;

R. BRUCE JOSTEN,
Executive Vice President, Government Affairs,
U.S. Chamber of Commerce.

cc: The Members of the U.S. House of Representatives

SUBMITTED STATEMENT BY HON. FRANK D. LUCAS; ON BEHALF OF 3M COMPANY

3M Company ("3M") is a large U.S.-based employer and manufacturer established more than a century ago in Minnesota. Today, 3M is one of the largest and most diversified technology and manufacturing companies in the world.

3M thanks the Committees for studying the critical details related to reforms to the U.S. financial system and for considering our perspective in this important debate. In examining the concepts outlined in the recent U.S. Treasury proposal on financial system reforms, 3M respectfully urges the Committees to carefully consider the distinct differences among various derivative products and how they are used, and encourages the Committees to preserve commercial users' ability to continue using derivative products to manage various aspects of corporate risk while addressing concerns about stability of the financial system.

Background on 3M

In 1902, five northern Minnesota entrepreneurs created the Minnesota Mining & Manufacturing Company, now known today as 3M. 3M is one of the largest and most diversified technology companies in the world. 3M is home to such well-known brands as Scotch, Scotch-Brite, Post-it, Nexcare, Filtrete, Command, and Thinsulate. 3M designs, manufactures and sell products based on 45 technology platforms and serves its customers through six large businesses: Consumer and Office; Display and Graphics; Electro and Communications; Health Care; Industrial and Transportation; and Safety, Security and Protection Services. 3M achieved $25.3 billion of worldwide sales in 2008.

Headquartered in St. Paul, Minnesota, 3M has operations in 27 U.S. states, including over 60% of 3M's worldwide manufacturing operations, employing 34,000 people. 3M's U.S. sales totaled approximately $9.2 billion in 2008. While its U.S. presence is strong, being able to compete successfully in the global marketplace is critical to 3M. 3M operates in more than 60 countries and sells products into more than 200 countries. In 2008, 64% of 3M's sales were outside the U.S., a percentage that is projected to rise to more than 70% by 2010.

Ahead of their peers, 3M's founders insisted on a robust investment in R&D. Looking back, it is this early and consistent commitment to R&D that has been the main component of 3M's success. Our diverse technology platforms allow 3M scientists to share and combine technologies from one business to another, creating unique, innovative solutions for our customers. 3M conducts over 60% of its worldwide R&D activities within the U.S.

Our commitment to R&D resulted in a $1.4 billion investment of 3M's capital in 2008 and a total of $6.8 billion during the past 5 years while producing high quality jobs for 3,700 researchers in the U.S. The success of these efforts is evidenced not only by 3M's revenue but also by the 561 U.S. patents awarded in 2008 alone, and over 40,000 global patents and patent applications in force.

Our success is also attributable to the people of 3M. Generations of imaginative and industrious employees in all of its business sectors throughout the world have built 3M into a successful global company. Our interest in speaking with you today is to preserve our ability to continue to invest and grow, creating substantive jobs and providing high quality products to a growing base of customers.

Treasury Proposal

Treasury Secretary Geithner proposed the establishment of a comprehensive regulatory framework for OTC derivatives that is designed to:

1. Prevent activities in those markets from posing risk to the financial system.
2. Promote the efficiency and transparency of those markets.
3. Prevent market manipulation, fraud and other market abuses.
4. Ensure that OTC derivatives are not marketed inappropriately to unsophisticated parties.

OTC Derivatives: Helping U.S. Companies Manage Risk in a Competitive Marketplace

While 3M unequivocally supports these objectives, we have strong concerns about the potential impact on OTC derivatives and 3M's ability to continue to use them to protect our operations from the risk of undue currency, commodity, and interest rate volatility.

Derivative products are essential risk management tools used by American companies in managing foreign exchange, commodity, interest rate and credit risks. The ability of commercial users to continue to use over-the-counter ("OTC") derivatives consistent with the requirements of hedge accounting rules is critical for mitigating risk and limiting damage to American businesses' financial results in volatile market conditions.

We urge policy makers to preserve commercial users' access to existing derivative products as you design new regulations. We share the following comments with you in the spirit of working together to address the concerns about the stability of the financial system:

1. Preventing Activities Within OTC Markets From Posing Risk To Financial System:

- We agree that the recent economic crisis has exposed some areas in our financial regulatory system that should be addressed. However, not all OTC derivatives have put the financial system at risk and they should not all be treated the same. The OTC foreign exchange, commodity, and interest rate markets have operated uninterrupted throughout the economy's financial difficulties. We urge policy makers to focus on the areas of highest concern, such as credit default swaps.
- We would like to work with policy makers to address oversight where warranted, *but recommend that it be targeted and not applied to all segments and market participants.*

2. Promoting Efficiency and Transparency within the OTC Markets:

- We understand the need for reporting and record-keeping. Publicly held companies are currently required by the SEC and FASB to make significant disclosures about their use of derivative instruments and hedging activities, including disclosures in their 10Ks and 10Qs.
- *We would like to work with policy makers on ways to efficiently collect information and enhance transparency.* Specifically, proposals have been made to establish a data repository for OTC derivatives to ensure transparency and disclosure. We understand and support this need for greater transparency and oversight and could support providing on a real-time basis the critical terms (amount, currency, counterparty, rate(s), maturity) for transactions over a specified minimum size (*e.g.,* $250,000) for such a data repository. Proposals have also been made to establish regulatory supervision of the data, and we would look forward to working with the regulating entity to develop oversight parameters and participant practices that would meet the goals established by Congress.
- **We oppose a mandate to move all derivatives into a clearing or exchange environment.** One key characteristic of OTC derivatives for commercial users is the ability to customize the instrument to meet a company's specific risk management needs. Provisions that would require the clearing of OTC derivatives would lead to standardization, thus impeding a company's ability to comply with the requirements of Financial Accounting Standard 133 (FAS 133). The inability to precisely hedge specific risks, whether currency, interest rates or commodities within the context of FAS 133, would expose

corporate financial statements to unwanted volatility and uncertainty. Results could include lower valuations for companies as well as a reluctance to undertake as many growth investments because of the need to maintain some dry powder for adverse impacts from unhedged financial risks.

◦ While we are mindful of the reduction in credit risk inherent in a clearing or exchange environment, robust margin requirements would create substantial incremental liquidity and administrative burdens for commercial users, resulting in higher financing and operational costs. Capital currently deployed in growth opportunities would need to be maintained in a clearinghouse. This could result in slower job creation, lower capital expenditures, less R&D and/or higher costs to consumers. Hedging in the OTC market is customized to fit the actual underlying business risks being hedged. The clearinghouse concept relies upon high volumes of standardized products, a characteristic that does not exist in the customized hedging environment of the OTC market.

By imposing initial and variation margin requirements, clearinghouses will add significant capital requirements for end-users, adding significant costs, discouraging hedging, and diverting scarce capital that could otherwise be used in further growing American businesses.

3. Preventing Market Manipulation, Fraud, and Other Market Abuses.

◦ We support the appropriate regulatory agencies having the authority to police fraud, market manipulation and other market abuses. The CFTC is utilizing its existing statutory and regulatory authority to add significant transparency in the OTC market, receive a more complete picture of market information, and enforce position limits in related exchange-traded markets. The comment period remains open on the CFTC proposal and this work should be allowed to continue.

4. Ensuring That OTC Derivatives Are Not Marketed Inappropriately to Unsophisticated Parties.

◦ We support modifications to current law that would improve efforts to protect unsophisticated parties from entering into inappropriate derivatives transactions.

"Clearing" in the OTC Market

The obvious benefits of clearing are the elimination of counterparty risk and the facilitation of "data collection" for executed transactions. By requiring a greater swath of derivatives to be cleared, the "costs" of trading (for both dealers and end-users) will rise. Increased costs will come in the form of trading fees, margin/capital requirements, and administrative burden associated with management of the margin requirements. This will likely result in:

1. an increase in market concentration among dealers, as marginal players lose profitability, and
2. a decrease in hedging among end-users, as margin requirements will pressure their capital/liquidity.

The second impact will likely hasten the concentration effect mentioned above. Further, a clearing environment requires the use of standardized instruments. Standardized contracts are unusable to most end-users, as they do not permit companies to precisely hedge the risks of their business. Any "mismatch" between business exposure and hedge instrument could result in the end-user's loss of hedge accounting treatment (FAS 133), thus creating additional income statement volatility.

We believe that clearing should only apply to some of the products. The currency, interest rate, and most of the commodity markets operated well throughout the recent financial crisis. Clearing, however, may be appropriate in other areas where authorities believe there is a high degree of systemic risk present. Likewise, clearing may be appropriate in the case of standardized instruments. Customized derivatives, however, need to be tailored to meet end-users' business risk management needs, making clearing problematic.

It is also important to remember that, particularly with interest rate swaps and foreign exchange, these are global markets. According to the Bank for International Settlements Triennial Central Bank Survey (December 2007), just 15% of daily FX turnover occurred in the United States, while 24% was the corresponding figure in the interest rate (single currency) market. U.S. based companies could be put at a disadvantage *versus* their foreign competitors should OTC trading regulations change dramatically in the U.S.

In addition, warehousing is not appropriate for all trades. For example, a large percentage of trades executed in the foreign exchange market (well over 50%) are of very short (1 week and under) duration. It would seem impractical to require warehousing for such transactions. Warehousing probably makes more sense for "term" transactions of longer maturity.

Conclusion

We thank the Committees for the opportunity to submit our comments in writing as an employer interested in preserving and enhancing the global competitiveness of American businesses and workers. 3M looks forward to working with you as the Committees crafts legislation to strengthen the U.S. financial system.

SUBMITTED QUESTIONS

Response from Hon. Timothy F. Geithner, Secretary, U.S. Department of the Treasury

Question Submitted By Hon. Steve King, a Representative in Congress from Iowa

Question. Over the past 12 to 18 months, American taxpayers have watched with great concern as their Federal Government has expanded its reach deeper and deeper into the inner workings of our free market economic system. As part of its efforts to stabilize our weakening economy, the government, led by the Department of the Treasury and the Federal Reserve, has injected billions of taxpayers' dollars into various private entities. What's more, the government has taken an ownership and/or significant financial interest in a number of these entities. In my view, and in the view of many of the Americans, the positions that the Federal Government has taken in these entities amounts to *de facto*—and in some cases outright—nationalization. To illustrate this point, I draw your attention to the relationship that the Federal Government now shares with eight formerly private entities:

- GM—Treasury has loaned $50B in taxpayer funds to GM and has taken a 61% controlling interest in the company. Taxpayers have also loaned $13.5B to GMAC and have provided $3.5B to the GM auto supplier support program. The U.S. Treasury's Warranty Support Program also backs GM's warranties.
- Chrysler—Treasury has loaned $12B in taxpayer funds to Chrysler and has taken a 9.85% equity stake in the company with a right to appoint four directors. The U.S. Treasury's Warranty Support Program also backs Chrysler's warranties. Taxpayers have also extended a $1.5B loan to Chrysler Financial and have provided $1.5B to the Chrysler auto supplier support program.
- Fannie Mae—Fannie is currently under Treasury-directed conservatorship and has received $34.2 billion in funding from taxpayers. The Federal Reserve also holds $71.5 billion in Fannie and Freddie's debt and holds $365.8 billion in mortgage-backed securities guaranteed by the firms.
- Freddie Mac—Freddie is currently under Treasury-directed conservatorship and has received $51.7 billion in funding from taxpayers. The Federal Reserve also holds $71.5 billion in Fannie and Freddie's debt and holds $365.8 billion in mortgage-backed securities guaranteed by the firms.
- AIG—The Federal Government replaced the company's CEO, has limited executive compensation, has provided $173.4 billion to AIG, and has taken a 79.9% stake in the company.
- Citigroup—The Federal Reserve has guaranteed losses on $306 billion of assets owned by Citigroup and Treasury has purchased $20B in Citigroup preferred shares.
- Bank of America—The Federal Reserve has guaranteed losses on $118 billion on assets owned by BOA and Treasury has purchased $20 billion of BOA preferred shares.
- Bear Stearns—As part of a government-structured deal for JPMorgan Chase to acquire Bear Stearns, the Federal Reserve purchased $30 billion of Bear Stearns' assets through a new LLC that the Fed created and controls.

Please detail for me the plan the Federal Government is following to end its financial and/or ownership interest in each of these entities and every other private entity in which it currently holds some ownership or financial interest. What is the government's exit strategy? What are the benchmarks that will be used to track the progress being made? I believe it is imperative that the American people be given a candid and thorough answer.

Answer. In late 2008 and early 2009, our country was in the midst of one of the most severe financial crises of the past century, and the economy was in danger of even further deterioration or collapse. The initial actions taken by the Federal Reserve and the U.S. Government at the onset of the financial crisis and the comprehensive, forceful, and sustained commitment to fiscal stimulus and financial stability made under the Obama Administration represented the first stage of our policy response. Now, in part as a result of these actions, we are entering the next phase of our efforts: moving from rescue of our financial system to a period of stabilization, rehabilitation, and rebuilding.

This next phase will focus on winding down those programs that were once necessary to prevent systemic failure. The use of those programs, by design, continues to decline as the financial system recovers, and the U.S. Government is being repaid for its investments. But this phase will also involve ensuring that those policies and programs that are still necessary for financial and economic recovery are maintained and well executed, making clear that the U.S. Government still stands ready to do whatever is needed to ensure a lasting recovery.

The government's exit strategy for each policy you identify is tied to its purpose. There are two basic categories. First, there are broad policies and programs designed to restore and sustain confidence in whole classes of financial institutions and the basic functioning of key financial markets. This includes capital injections for banks, bank liability guarantees, support for money market mutual funds and the commercial paper market, initiatives to encourage lending to consumers and businesses, and programs to stabilize the housing markets. Second, there are narrow initiatives designed to support key financial institutions.

I. Stabilization Policies

The broad policies aimed at stabilizing the financial system were designed to terminate naturally. In part, the programs were designed to protect taxpayers' interests by being increasingly expensive for participants. Fees and other pricing aspects make them increasingly unattractive as time passes and financial conditions stabilize. Indeed, utilization of many of these programs has already declined substantially as the participants have succeeded in raising capital in private markets. Further, many of the programs have sunset provisions. Below, we discuss these aspects of each of the major programs.

A. Troubled Asset Relief Program (TARP)

Treasury has used TARP authority to make a little over $200 billion in capital injections in banks through the Capital Purchase Program (CPP). This program was designed to stabilize the banking system, because banks' balance sheets had been severely impaired during the crisis due to losses on mortgage-related assets, increased borrowing costs, and collapsing share prices. CPP funds were disbursed as investments in which Treasury received preferred equity (or subordinated debentures in some cases) and warrants. The preferred equity provides dividends of five percent for the first 5 years of the investment and nine percent thereafter.

Over $70 billion invested under the CPP has already been repaid. In other words, Treasury has recovered over a third of its CPP investment. In addition, Treasury has received roughly $10 billion in income from CPP investments, including dividends, interest, fees, and proceeds from the sale of warrants and some preferred equity. For the 23 institutions in which Treasury's CPP investments have been fully repaid, Treasury earned an annualized average return of 17 percent.

The Supervisory Capital Assessment Program (SCAP), more commonly known as the "stress test," contributed to the repayments to date by helping to convince market participants that major banks could absorb the losses that might come with an adverse economic scenario. The enhanced market confidence enabled financial institutions to raise new capital which was used to repay Treasury.

Treasury's authority to make new commitments under the CPP and other programs authorized by the Emergency Economic Stabilization Act of 2008 (EESA) will expire on December 31, 2009, unless the Secretary of the Treasury decides to extend that authority to no later than October 3, 2010. Therefore, the ability to provide new assistance under EESA is limited to a time frame set by the law.

B. Money Market Mutual Fund Guarantee Program

At the height of the crisis last fall, Treasury established the Money Market Mutual Fund Guarantee Program to prevent a run on money market mutual funds in the wake of the failure of Lehman Brothers and the well-publicized troubles of several large funds. This program—which provided protection for about $2.5 trillion in investments—expired on September 18. Due to improved market confidence, Treasury has determined that it does not need to establish a successor program. Since inception, Treasury has had no losses under this program. In fact, it has earned the U.S. Government $1.2 billion in fees.

C. FDIC Programs

In response to the financial crisis, the FDIC's role as guarantor of liabilities of depository institutions was expanded. Specifically, the FDIC began insuring non-interest-bearing transaction accounts and short- and medium-term senior unsecured debt issued under its Temporary Liquidity Guarantee Program (TLGP).

Like the Treasury's CPP program, TLGP was designed to be expensive for participants once market conditions improved. Early in the program, fees to issue debt under the TLGP ranged between 50 to 100 basis points, depending on maturity. The FDIC increased those fees on April 1, 2009, by 25 to 50 basis points. To date, the fees have generated roughly $9 billion in income. As markets have stabilized, the cost of borrowing in private markets has declined to levels that make TLGP fees unattractive, and utilization of the TLGP debt guarantee program has declined. Issuance peaked at $113 billion in December and was roughly $2 billion in August. In addition, the stock of guaranteed debt has fallen by nearly $50 billion since early June.

These programs are also subject to "sunset" provisions. After receiving comments and determining that the program was still necessary for market stability, the FDIC recently extended the guarantee on transaction accounts under the TLGP to June 30, 2010. However, in doing so it increased the fee from 10 basis points to 15–25 basis points, depending on an institution's risk category. This fee increase will help ensure that the program is self-funding and does not impose losses on the Deposit Insurance Fund.

The last day for new issuance under the TLGP senior debt guarantee program is currently October 31, 2009. On September 9, 2009, the FDIC Board of Directors approved the phase out of this program as scheduled. In conjunction with this phase out, the FDIC is seeking comment on whether a temporary emergency facility should be put in place for 6 months after the expiration of the current program. Such a facility could provide additional guarantees for new issuance, at a substantially higher fee, in the event that participants are unable to access credit markets due to market disruption or other events beyond their control.

D. Federal Reserve Programs

The Federal Reserve has implemented a number of programs designed to stabilize financial markets since the onset of the crisis. One set of programs provides liquidity directly to borrowers and investors in key credit markets. Such programs include the Commercial Paper Funding Facility (CPFF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), the Money Market Investor Funding Facility (MMIFF), and the Term Asset-Backed Securities Loan Facility (TALF).

Utilization of these liquidity programs has declined as market conditions have improved. For example, credit extended under the CPFF has declined from a peak of $350 billion in January to $46 billion recently, and lending under the AMLF has fallen from $152 billion to $79 million. The Federal Reserve charges interest on loans under each of these programs. Further, the Federal Reserve announced that it will terminate the MMIFF on October 30, the CPFF and AMLF on February 1, 2010, and the TALF on June 30, 2010.

II. Policies to Support Systemically Significant Institutions

The government's interventions to support specific systemically significant companies during this crisis have been focused on the objective of stabilizing the financial sector and the economy while protecting the taxpayers' investment. We have set clear principles to ensure that our investments in those companies are limited and temporary. We will not seek to participate in the management of their day-to-day operations. We will exit these investments as soon as practical, while protecting taxpayers and promoting financial stability.

A. Auto Industry

The New General Motors and the New Chrysler recently emerged from expedited bankruptcies. The government's support in that process has prevented substantial job losses, led to orderly restructurings, and helped stabilize economic and financial markets. In exchange, the taxpayer received a combination of debt, preferred equity and equity, along with a government commitment to manage those investments commercially and exit from the investments as quickly as is practicable.

The government has been a reluctant shareholder in General Motors and Chrysler. It committed tax dollars on the strict condition that these companies and their stakeholders were willing to fundamentally transform, address prior bad business decisions, and chart a path toward long-term financial viability without ongoing government assistance. The government rejected the initial viability plans of both companies, and it was only after a lengthy process that acceptable plans were formulated and implemented, which involved sacrifices and commitments from all stakeholders. Throughout the restructuring process, the Auto Task Force has refrained from intervening in the day-to-day decisions of these companies. Such intervention could seriously undermine the companies' long-term viability and, consequently, the government's ability to maximize the recovery of taxpayer dollars.

The termination of the Auto Warranty Commitment Program demonstrates the government's prudent use of taxpayer funds and commitment to exit. The government invested $641 million in the Warranty Program to give confidence to GM's and Chrysler's customers during a period of substantial uncertainty. Following the companies' emergence from bankruptcy, the money invested in the program has been returned, along with interest payments from New Chrysler. Similarly, Treasury has decreased the commitments under the Auto Supplier Support Program to $2.5 billion and $1 billion for GM and Chrysler, respectively.

We also note that Chrysler Financial has fully repaid the investment made by the government.

B. Government-Sponsored Enterprises

Government-Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac experienced substantial losses from exposure to the housing market during the crisis. In September 2008, they were placed in Federal conservatorship.

The government has invested directly and indirectly in the GSEs to maintain liquidity in the residential mortgage market. Treasury entered into Preferred Stock Purchase Agreements (PSPAs) with the GSEs, whereby Treasury purchased preferred equity in the companies and committed to provide funding to the companies to compensate for shortfalls in earnings, up to a maximum of $400 billion combined for both entities. The GSEs have received approximately $96 billion under these agreements and paid the government over $2 billion in dividends on the preferred equity. Treasury and the Federal Reserve also established credit lines for the GSEs. Neither has been used. Finally, Treasury and the Federal Reserve have been purchasing mortgage-backed securities (MBS) guaranteed by the GSEs, and the Federal Reserve has also purchased GSE-issued debt.

The government's exit strategy for the GSEs varies by program. Purchases under the PSPAs are limited to $400 billion in the aggregate. Treasury's credit facility is scheduled to terminate at the end of this year. Treasury will also complete its purchases of GSE MBS by the end of 2009, while the Federal Reserve anticipates that it will complete its purchases of GSE MBS and direct obligations by the end of the first quarter of 2010. Treasury can hold its portfolio of GSE MBS to maturity, and, based on mortgage market conditions, Treasury may make adjustments to the portfolio.

Improving market conditions have benefited the GSEs. Their cost of borrowing has come down dramatically since the peak of the crisis, and the Federal Reserve has slowed its purchases of GSE debt. Freddie Mac reported positive net income and net worth for the second quarter of 2009, while losses slowed at Fannie Mae. As a result, requested draws under the PSPAs fell to $11 billion in the past quarter.

The government's investments and the conservatorship process have helped keep mortgage rates at affordable levels for American families and we look forward to working with Congress on the long term structure of the GSEs.

C. American International Group (AIG)

Treasury and the Federal Reserve have provided credit to AIG in the form of equity purchases (Treasury) and secured lending (Federal Reserve). The Federal Reserve Bank of New York (FRBNY) provided a credit facility in September 2008, and in connection therewith it received convertible preferred shares. In November 2008, Treasury purchased $40 billion in cumulative preferred shares from AIG which was used to reduce some of the FRBNY's credit facility. In April 2009, Treasury exchanged those cumulative preferred shares for $41.6 billion in non-cumulative preferred shares and also created an equity capital facility, which expires no later than April 17, 2014, under which AIG may draw up to $29.8 billion as needed. The preferred equity provides a ten percent dividend, and AIG has requested a little over $3 billion to date through the Treasury facility.

It should be noted that the FRBNY contributed the convertible preferred shares to a trust for the benefit of the taxpayer. The trust is managed by independent trustees who are not government employees. These trustees have the discretion to vote the shares, which represent approximately 80% of the voting rights of the outstanding common stock. They have elected a new board of directors, and that board has chosen a new chief executive officer.

AIG's new management is working to unwind the complex financial transactions that have generated substantial losses for the firm, and they are working to improve the viability of the firm's core businesses. Treasury will continue to work with the Fed and AIG to maximize the recovery of taxpayer dollars.

D. Citigroup and Bank of America

The government has invested in Citigroup and Bank of America through two programs: CPP and the Targeted Investment Program (TIP). The government also provided guarantees to Citigroup pursuant to the Asset Guarantee Program (AGP).

Through the TIP, the government purchased $20 billion in preferred equity in each company. It also received warrants. The preferred equity pays eight percent in dividends.

Only Citigroup has entered into an agreement with the government to participate in the AGP. It is structured as a loss-sharing agreement for $301 billion in residential and nonresidential assets. Citigroup is responsible for the first $39.5 billion of losses on the assets. Treasury covers $5 billion of the next loss, with Citi covering an additional $0.55 billion. The FDIC guarantees the next $10 billion in losses, and Citi covers an additional $1.1 billion. The Federal Reserve would then provide a secured loan equal to 90 percent of the remaining value in the pool collateralized by those assets, with Citi covering other losses.

In return for their support under the AGP, Treasury and the FDIC have received roughly $7 billion in Citi preferred equity, which provides cumulative dividends of eight percent. There have been no claim payments to Citi under the guarantee.

As part of an exchange offer to strengthen Citigroup's tangible common equity capital, Treasury converted the preferred stock received under the CPP investment for common stock which has increased significantly in value. Treasury and the FDIC also converted the preferred stock received under the TIP and AGP transactions for trust preferred securities.

On January 15, 2009, Treasury, the Federal Reserve, and the FDIC signed a term sheet with Bank of America to provide a guarantee of losses on $118 billion in assets. The parties never entered into a definitive agreement, and on September 21, 2009, the parties entered into a termination agreement with respect to this arrangement, under which Bank of America paid the government a total of $425 million. The fee was paid because Bank of America received value from the agreed-to term sheet, including the representation that the government would guarantee losses from and after January 15, 2009 and the benefits that signing the term sheet had on market confidence in the company. The fee was equal to the fee that would have been payable had the definitive documentation been entered into, as adjusted for the shorter period and for certain changes to the asset pool that were discussed in the negotiations.

We will continue to work with Citi, Bank of America, and their regulators to ensure that they can repay the taxpayer as soon as they are able.

E. Bear Stearns/JPMorgan

The Federal Reserve has not directly purchased any assets of Bear Stearns. It has provided approximately $29 billion in loans secured against former Bear Stearns assets in an entity called Maiden Lane LLC. The Federal Reserve is a senior creditor and receives interest payments for its senior loan.

The Federal Reserve retained an outside financial advisor to manage the assets held in the Maiden Lane LLC portfolio. The advisor's primary objective is to pay off the senior loan, including principal and interest, while refraining from investment actions that would disturb general financial market conditions. Financial statements for the LLC are available at *http://www.newyorkfed.org/markets/maidenlane.html.*

III. Transparency and Oversight

Treasury, FDIC, and the Federal Reserve all publish detailed information regarding their financial programs online and in printed publications. Treasury recently published a report entitled *The Next Phase of Government Financial Stabilization and Rehabilitation Policies,* which is available at: *http://www.financialstability.gov/latest/09142009_statusReport.html.*

In addition, details regarding Treasury programs authorized by EESA, including new investments and repayments, are reported on the Treasury's website: *http://www.financialstability.gov/.*

The FDIC publishes details of its programs, along with monthly and quarterly reports, at: *http://www.fdic.gov/regulations/resources/TLGP/index.html* and *http://www2.fdic.gov/QBP/index.asp.*

The Federal Reserve provides details of its programs at *http://www.newyorkfed.org/* and in reports and testimony available at: *http://www.federalreserve.gov/monetarypolicy/bst.htm* and *http://www.federalreserve.gov/monetarypolicy/mpr_default.htm.*

Several entities provide oversight of the government's financial programs. For example, Treasury continues to work with the Special Inspector General for TARP and the Congressional Oversight Panel to improve transparency and management of its programs. Publications and testimony from these oversight bodies can be found at: *http://www.sigtarp.gov/* and *http://cop.senate.gov/,* respectively.

The Office of Management and Budget and the Government Accountability Office (GAO) also provide oversight of Treasury and FDIC programs. The Federal Reserve is subject to oversight by Congress. Board governors and staff testify before Congress frequently to discuss issues within the Federal Reserve's purview. The GAO also has broad authority to review and audit Federal Reserve activities. And the Board of Governors and Reserve Banks undergo internal and external audits.

Question Submitted By Hon. Erik Paulsen, a Representative in Congress from Minnesota *

Question. Some are proposing that all derivatives have to either go on an exchange or be cleared. There are obvious problems with trying to shoe-horn customized derivatives onto an exchange. There are also significant costs to end-users to forcing derivatives to be cleared. While many talk about the over 90% of Fortune 500 companies that safely and prudently use customized OTC derivatives today, it is also true that half of the mid-sized firms and thousands of smaller U.S. companies also use these tools to manage specific financial risks. Do you agree that requiring all derivatives to be cleared will lead to margin requirements for all end-users? Do manufacturers have liquid collateral for these margins easily at hand right now?

In response to concerns about the costs to clearing, I've heard some say that companies will either find the money, or maybe fewer derivatives will be used—and they are ok with that. But companies—big and small—use these derivatives to protect against risks they face. What happens to companies that can't find the collateral to finance the use of derivatives? Would the company face more or less risk in their day to day business? And is it in the best interest of the economic growth of U.S. business to have capital tied up this way *versus* investing it in research, plants or jobs?

The strict mandate for cash margin and collateral within the clearinghouse environment has been pointed to as a severe constraint on the end-users of OTC derivatives. End users say that they often use plants and equipment and even real estate as collateral in their current bilateral contracts. Clearing houses I understand have to require cash under their regulatory rules. What are your thoughts on the need to omit cash margin/collateral and provide broad flexibility? By allowing real estate and other seemingly illiquid sources for collateral/margin are we setting the stage for the next risk bucket or should cash be king in this arena in light of recent events?

Banks currently use CLS (Continuous Linked Settlement Bank) for foreign exchange settlements. On average CLS settles up to $10 trillion each day in foreign exchange related payment obligations and has been recognized by G10 central banks as a significant mitigator of settlement risk in the foreign exchange market. Given that a platform like this already exists in the foreign exchange market, do you support significant modifications to the way the foreign exchange market works and if so, why?

Question Submitted By Hon. Bill Cassidy, a Representative in Congress from Louisiana *

Hon. TIMOTHY F. GEITHNER,
Secretary,
U.S. Department of the Treasury.

Question. At the July 10, 2009 House Agriculture/Financial Services Committee joint hearing, we spoke regarding the effects of the Administration's proposal on publicly-owned utilities.

As follow up, not-for-profit public utilities have asked if prepayment transactions utilizing tax-exempt financing for the prepayment of contracts would be eliminated and are concerned that the imposition of cash-margin requirements would drive up costs to consumers.

* There was no response from the witnesses by the time this hearing went to press.

How does the Administration propose to mitigate cash-margin requirements for these public not-for-profit hedgers? In addition, has the Administration considered imposing additional reporting requirements for over-the-counter market transparency without the standardized clearing requirement?

I appreciate your attention to these important questions as Congress continues to work with you on striking the appropriate balance between preserving stability in our markets and fostering innovative methods for market participants to manage risk.

Sincerely,

Bill Cassidy

Hon. BILL CASSIDY,
Member of Congress.