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Yale Program on Financial Stability
Lessons Learned

Brooksley Born

By Maryann Haggerty

Brooksley Born, a lawyer with decades of experience in derivatives law, served as chair of the Commodity Futures Trading Commission (CFTC) from 1996 to 1999. At the CFTC, she advocated for federal regulation of the over-the-counter derivatives (OTC) market, but legislation failed to pass. The OTC derivatives market had a central role in the Global Financial Crisis of 2007-09. Born, who returned to private practice after her CFTC term, served as a commissioner on the US Financial Crisis Inquiry Commission, which investigated the causes of the crisis and issued its report in January 2011. This "Lessons Learned" is based on an interview with Ms. Born.

The financial services industry has great political power.

During Born's term as chair of the CFTC, she was engaged in a contentious debate about the fast-growing and lightly regulated OTC derivatives market. She recalled, "We were asking questions about central clearing, use of transaction execution facilities, exchange-like or online, requirements for OTC derivatives dealers like record keeping, reporting, sales practice requirements, capital requirements, disclosure requirements, and internal controls." Those ideas were contained in what was called a "concept release" that discussed possible regulations. "When we published the concept release in May 1998, there was a firestorm of opposition." The industry actively opposed regulation. Many in government agreed, but Born did not.

She described the opposition this way,

> The political power of the financial services industry has led to a significant degree of regulatory capture among federal financial regulators and undue deference to the industry by members of Congress.
>
> … There was fierce opposition from all of the big over-the-counter derivatives dealers, which were our largest financial institutions. This unregulated, nontransparent market was, as we discovered later, one of their largest profit centers. They were making a tremendous amount of money, partly because the market was not transparent and was not competitive. There was often little clear pricing information available to their counterparties. The dealers wanted to preserve this lack of transparency.
>
> There had been 20 or 30 years of deregulatory pressures, largely stimulated by the financial services industry, but also championed by people like Federal Reserve Board Chair Alan Greenspan. The financial services industry at this point had great political power. They were among the very largest campaign contribution donors. They had large forces lobbying before both Congress and the executive branch financial regulators. And they exerted a tremendous amount of power.

While it can never be predicted whether more regulation could help avoid effects that create systemic risk, all sides of the argument and possible long-term impacts are worth considering.

In 1998, while Born was chair, the CFTC issued a "concept release" reexamining its approach to the OTC derivatives, which were then exempt from regulation, and seeking public comment. The release identified observed developments in derivatives innovation, raised concerns about the sufficiency of the current regulatory scheme, and proposed enhanced regulation. Many of Born's colleagues and industry leaders felt that enhanced regulation was not necessary and would dampen the market's growth. Two years later, the Commodity Futures Modernization Act of 2000 further deregulated OTC derivatives trading. The result, in Born's view, was that a dangerous industry was allowed to grow unchecked, threatening the stability of the rest of the system.

She said,

> Adequate information about the over-the-counter derivatives market would have made a tremendous difference. If this had been a regulated market, it would have been transparent. Federal regulators would have been able to see the size of the positions, the extent of the trading, the amount of speculation, and the interconnectivity among market participants. They could have stepped in when they saw the extent of counterparty credit risk, to require central clearing, reducing the risk by interposing the clearing facility between the parties. They could have seen the extent of speculation that was inflating the risk posed by the mortgage market by multiplying it exponentially in terms of potential losses.

The unregulated OTC derivatives market created systemic risk that fed the financial crisis.

The OTC derivatives market grew steeply and quickly in the early 2000s, reaching more than $670 trillion in notional value by the time of the 200709 financial crisis. (Notional value is the value of the securities that underlie derivatives.) Born was a member of the federal Financial Crisis Inquiry Commission (FCIC), which examined the causes underlying that crisis in the United States, including the role of derivatives. Among the types of derivatives examined were credit default swaps (CDS) and collateralized debt obligations (CDOs), both of which allowed bets on packages of mortgages.

Speaking of the FCIC's findings, Born elaborated,

> What we found in terms of over-the-counter derivatives was that allowing this enormous unregulated market to grow without oversight or regulation led to substantial financial systemic risk and contributed to the magnitude of the crisis. The market was not transparent. It was highly leveraged. There was excessive speculation. It created interconnections between systemically important financial institutions that had the effect of allowing losses to cascade through the system.

> … In addition to the role played by credit default swaps in the financial crisis, the FCIC found that the interconnections created by over-the-counter derivativesof all kinds among the biggest financial institutions, and also with other large corporations and institutions, caused rippling effects of losses to spread throughout the financial system and multiplied the risks in the financial crisis.For example, when Lehman Brothers went into bankruptcy in September 2008, it was a party to more than 900,000 over-the-counter derivatives contracts. Its failure created panic in the market and almost brought down thefinancial system.

Despite increased post-crisis regulation, much of the OTC derivatives market remains opaque and thus a threat to financial stability.

The Dodd-Frank Act, the package of US financial market regulatory changes adopted in the wake of the Global Financial Crisis, increased oversight of the derivatives market to a degree. Among other changes, it required central clearing of some types of derivatives, a process that reduces direct counterparty risk, though it may shift risk to the clearinghouse.

However, as of year-end 2020, there was still more than $600 trillion (notional value) of OTC derivatives outstanding, "and probably less than half of that is subject to central clearing," Born pointed out. In her view, regulators still do not have the insight they need into this market.

As an example, she discussed a recent event,

> We just had the collapse of Archegos. That seems to be a replayof Long-Term Capital Management in 1998. It is a large, unregulated investment vehicle speculating through over-the-counter derivatives, this time a kind of security swap, with virtually unlimited leverage. It avoided disclosure of its position as required by the securities laws by using over-the-counter derivatives that mimicked securities. It entered into these transactions through a number of over-the-counter derivatives dealers which probably had no idea that the entity was exposed to large positions taken with several other dealers. Goldman Sachs, Nomura, Deutsche Bank, Credit Suisse, and others were its dealers. Suddenly Archegos was unable to meet its collateral obligations on its contracts and defaulted. Luckily, it looks like Archegos' collapse did not cause cascading losses through the financial system that could not be contained. Apparently, its dealers were able to manage the substantial losses they have incurred. But it does show that this is still a dark, highly leveraged, and speculative market. There is a large part that is unknown to anybody. This may be the result of a failure on the part of the Securities and Exchange Commission to adequately and fully implement and enforce the Dodd-Frank Act's requirements as to securities-based, over-the-counter derivatives.

Necessary transparency can be achieved, "very easily," she said.

> You require virtually all of the market to be traded on regulated exchanges, open and transparent to the public and to the regulators. Competitive trading on such exchanges will provide necessary price discovery.You also require virtually all of the

> market to be cleared through a regulated central clearing operation with rigorous margin requirements, marking to market of the pricing, and position limits on speculation. That is the playbook that the regulated futures and options markets have operated under for decades as provided in the Commodity Exchange Act.

The industry will resist, she opined. That presents a critical challenge to officials,

> Again, and I am repeating myself, it is very important for policymakers, regulators, and supervisors to distance themselves from thinking that their purpose is to further the interest of a particular industry. It is very easy when enormous political power and money are being expended by an industry to forget that the industry's interests are not the public interest. And there is no reason to have regulation if it is not to further the public interest.

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