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Gary Gensler Follow Up From Wendy Edelberg

Wendy Edelberg

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August 23, 2010

Via Email and Mail

The Honorable Gary Gensler
c/o Mr. Timothy Karpoff
Counsel to the Chairman
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581
TKarpoff@CFTC.gov

Phil Angelides
Chairman

Hon. Bill Thomas
Vice Chairman

Re: Financial Crisis Inquiry Commission Hearing on July 1, 2010

Dear Mr. Gensler:

Thank you for testifying on July 1, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by September 7, 2010.¹

Brooksley Born
Commissioner

Byron S. Georgiou
Commissioner

Senator Bob Graham
Commissioner

Keith Hennessey
Commissioner

Douglas Holtz-Eakin
Commissioner

Heather H. Murren, CFA
Commissioner

John W. Thompson
Commissioner

Peter J. Wallison
Commissioner

1. A clearing house or, in other words, a central counterparty that assumes the credit risk on derivatives, needs to accurately assess risk in order to set margin requirements sufficient to avoid losses at the clearing house. Please explain why a clearing house will be better at assessing how much margin it must take on to avoid losses than existing counterparties to bilaterally cleared credit default swaps. Also, please explain why the market conditions such as we have recently experienced in the financial crisis would not cause losses to a clearing house.
2. AIG failed in a disrupted market. If AIG had failed in a market where most other financial institutions were in good financial condition would there have been a need to rescue it? When AIG was rescued,

¹ The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on April 9, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

Wendy Edelberg
Executive Director

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were AIG's interconnections throughout the market the problem or was the problem simply the perceived weakness of other institutions at the time?

3. In regards to the consequences of the Lehman bankruptcy, other than losses at the Reserve Fund's Primary Fund (which held Lehman short-term debt), is there any evidence that other institutions actually were significantly financially distressed as a result of the Lehman failure?

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Sarah Knaus at (202) 292-1394 or sknaus@fcic.gov if you have any questions or concerns.

Sincerely,



Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission

Federal Crisis Inquiry Commission
July 1, 2010
Questions for the Record

Gary Gensler, Chairman, Commodity Futures Trading Commission

- A. A clearing house or, in other words, a central counterparty that assumes the credit risk on derivatives, needs to accurately assess risk in order to set margin requirements sufficient to avoid losses at the clearing house. Please explain why a clearing house will be better at assessing how much margin it must take on to avoid losses than existing counterparties to bilaterally cleared credit default swaps. Also, please explain why the market conditions such as we have recently experienced in the financial crisis would not cause losses to a clearing house.

Centralized clearing has helped lower risk in the futures markets for decades in both calm markets and in the stormiest of markets, such as during the 2008 financial crisis. In contrast, in the swaps marketplace, transactions stay on the books of the derivatives dealers often for many years. This enables dealers to become dangerously interconnected with each of their counterparties as we saw with AIG.

As long as financial entities remain interconnected through their derivatives, one entity's failure could mean a run on another financial entity and a difficult decision for a future Treasury secretary. Clearinghouses move the risk off of the books of the dealers and into robustly regulated central counterparties. They lower risk through the daily discipline of marking each position cleared to the market price using independently determined prices. Gains and losses that arise as a result of the mark-to-market process are settled each day. As extra protection against potential market changes not covered by the daily mark-to-market, clearinghouses require daily posting of margin to cover changes in a swap's value.

Regulated clearinghouses are better equipped to impose margin requirements than the counterparties to bilaterally cleared credit default swaps. Clearinghouses are exclusively in the business of clearing trades and managing the associated risk. Unlike the parties to a transaction, clearinghouses do not have any potentially conflicting incentives or objectives when establishing margin requirements for a transaction. Unlike bilateral counterparties clearinghouses act in the middle between sellers and buyers and thus do not assume market risk.

One lesson of the recent financial crisis was that institutions were not just "too big to fail," but also "too interconnected to fail." Mandated clearing would reduce interconnectedness and thereby mitigate the types of risk presented by swaps dealers. It is worth noting that, throughout the entire financial crisis, trades that were carried out through regulated exchanges and clearinghouses

continued to be cleared and settled. Taxpayers were not asked to cover the costs of any cleared derivatives transactions.

- B. AIG failed in a disrupted market. If AIG had failed in a market where most other financial institutions were in good financial condition would there have been a need to rescue it? When AIG was rescued, were AIG's interconnections throughout the market the problem or was the problem simply the perceived weakness of other institutions at the time?

It is difficult, if not impossible, to separate AIG's failure from the economic and financial market environment in which it failed. The inquiries into AIG in the last two years indicate that, in 2008, AIG and its derivatives book posed a substantial risk to other financial institutions. AIG's CDS obligations to other entities were substantial in absolute terms, which endangered AIG's as well as the financial markets in general. Moreover, the number of entities to which these obligations were owed was many. Thus, AIG was interconnected with a large number of other financial institutions, which themselves were similarly interconnected with numerous other financial institutions. As a result, AIG's failure would likely have had significant repercussions for many in the financial markets.

- C. In regards to the consequences of the Lehman bankruptcy, other than losses at the Reserve Fund's Primary Fund (which held Lehman short-term debt), is there any evidence that other institutions actually were significantly financially distressed as a result of the Lehman failure?

The Lehman bankruptcy had significant effects in many different areas of the financial sector. Aside from the well-publicized experience of the Reserve Fund, reports indicate that many other money market mutual funds experienced unusually high rates of redemption. In addition, interbank lending and the short-term funding markets significantly dried up. Risk premiums on banks increased as evidenced in the CDS market. These events also were seen in the prime brokerage business and in the behavior of hedge fund clients. Securities that many of Lehman's prime brokerage clients had left with Lehman were frozen in bankruptcy proceedings in the United Kingdom. The inability to have access to this property caused financial difficulties for these clients. Beyond that, many other asset managers began to pull securities out of prime brokerage relationships with other investments banks further threatening the funding of these financial institutions and the markets.