Statement by

E. Gerald Corrigan

Managing Director

Goldman, Sachs & Co.

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Madame Chairwoman and Distinguished Members of the Committee on Economic and Monetary Affairs, I appreciate the opportunity to appear before you this afternoon in order to share with you some insights on the subjects of "Perspective on Sovereign Debt Management" and "Facilitating Derivatives Markets Surveillance." Both of these subjects are timely, very important and very, very complex.

While I am not an expert on the day-to-day details of sovereign debt management, my experience both in the Federal Reserve and in the private sector – including playing a role in helping to resolve the Latin American Debt Crisis in the 1980's and the Asian Debt Crisis in the 1990's provides a useful benchmark in thinking about the current challenges facing many countries as they struggle to cope with the debt management problems associated with very large budget deficits.

As a part of the perspective on debt management, we must recognize that financial reporting by sovereigns – as with private companies – is more an art than a science in that the "rules of the road" cannot anticipate every contingency nor every eventuality that may arise. For example, in many, if not most, countries there are financial obligations of governments that are not always captured directly in the budget. Pension obligations for retired workers, the contingent costs of various forms of governmental guarantees and certain classes of securitizations are cases in point. These examples are illustrations of why it is so important that we have institutions such as Eurostat here in Europe, the Congressional Budget Office in the United States, and independent standard setters for accounting policy and practice. The accounting and financial reporting requirements of state-owned or controlled companies are another example of the complexity of this subject matter. In the United States this issue now includes – at least for the time being – the de-facto government ownership of the two federally sponsored housing agencies.

The fact of these and other challenges is why the debt management process must be guided by certain core principles including the following:

First, debt management policies and practices must recognize the fundamentals. For example, financial markets and the public at large are willing – for a period of time – to give the benefit of the doubt as to the implications in individual countries of large budget deficits. But if such deficits persist – much less grow – tolerance fades and ultimately disappears. When this occurs, the challenges of debt management and rising debt servicing costs will escalate sharply.

Second; organizations such as Eurostat must have a very high degree of political independence. Indeed, a strong case can be made that political independence for Eurostat is every bit as important as it is for the European Central Bank.

Third; as a general matter, central banks should not directly participate as buyers of newly issued government securities by their own sovereign even though they will always be major participants in the secondary market for government securities.

Fourth; optimizing maturity profiles – even when it might be expensive – is vitally important. In that connection, soliciting the views and advice of private market makers on a wide range of issues regarding debt management tactics and strategy is always helpful. This is one of the reasons why most countries have in place a designated group of so-called "primary dealers" in government securities.

Fifth; state of the art systems providing virtually real time payment versus delivery capabilities for the issuance and trading in government securities is critical because such technical infrastructure helps to provide both liquidity and price discovery in the market for government securities thereby helping to ensure public and investor confidence in such markets.

Finally; the financial reporting and accounting standards for sovereigns must be as clear and transparent as possible and, over time, should strive to achieve, to the extent possible, international consistency. Indeed, the case for moving toward greater cross-border harmony in generic guidelines and principles regarding sovereign financial reporting is quite compelling.

These principles are not a panacea; deficits are deficits and they must be financed. But, to the extent these principles are adhered to they will help to create and sustain an open and robust marketplace for government financing. At a minimum, such a market environment will work in the direction of market efficiency and help to contain debt servicing costs.

Allow me to now turn to the equally complex and often controversial subject of "Facilitating Derivatives Market Surveillance." While this subject commands and is receiving heightened attention on the part of legislators and regulators on a global scale we must not lose sight of the fact that over the past several years very substantial progress has been made in improving the financial infrastructure associated with OTC derivatives markets. Indeed, the infrastructure of these markets – and therefore their liquidity – held up quite well during the financial crisis raising the likelihood that losses incurred by some sophisticated market participants were more of a matter of shortcomings in risk monitoring and risk management than they were a matter of fatal flaws inherent in the design of financial instruments such as credit default swaps.

At the risk of appearing self-serving, I would suggest that the work of the 2005 and 2008 Counterparty Risk Management Policy Groups (both of which had participants from European Banks), of which I was the Chairman, played a leading role in raising multiple "red flags" regarding infrastructure weaknesses amid the remarkable growth in these markets. Fortunately, and owing to the leadership of the New York Fed and the international community of Central Banks and other regulators – including officials from Europe – very substantial progress was made over the past five years in mitigating these structural weaknesses. Indeed, I will stipulate that were it not for these initiatives, the financial crisis would have been even worse – perhaps much worse – than it was.

A short list of some of the more important initiatives that were successfully implemented includes the following.

- Within two to three months of the publication of the July 27, 2005 CRMPG Report, the market practice of one counterparty "assigning" (or effectively selling) a derivative position without the explicit consent of the other counterparty was brought to a halt.

- In late 2005, and in partnership with the international official community, a highly successful program was commenced to mitigate the frightening backlog of unsigned trade confirmations in the credit default swap market.

- Reflecting in part the leadership of ISDA, a highly successful cash settlement system is now in place which has facilitated the net settlement of CDS positions in connection with the default or bankruptcy of a number of major market participants including Lehman Brothers.

- Voluntary "trade compaction" initiatives by leading market participants have reduced the notional amount of outstanding CDS by tens of trillions of dollars.

- Within a few short weeks of the publication of the August 6, 2008 CRMPG Report, the international community of dealers – after years of negotiations – agreed on a common method for position close outs involving a defaulted counterparty. Fortunately, this agreement was in place when, a few weeks later, Lehman declared bankruptcy.

- Finally, after protracted discussions among market participants, regulators and various industry groups, regulated "Centralized Counterparty Clearing" facilities (CCPs) for various classes of transactions starting with CDS have commenced operations. While full implementation of such clearing facilities will take time, the CCP innovation should bring about significant reduction in systemic risk associated with derivatives trading, especially as pertaining to credit default swaps. However, CCPs will also tend to concentrate risk. For this reason, all CCPs should be regulated to ensure the highest standards of financial and operational integrity. In this regard, I and others have suggested that all CCPs should be able to withstand the same day default of their two largest members – an outcome that will call for recurring and rigorous stress tests.

While the progress I have outlined in strengthening the infrastructure of OTC derivatives markets is impressive, those efforts are far from complete. That is why in the United States and across the community of nations, legislative and regulatory bodies are in the advanced stages of further and substantial steps to strengthen the stability and soundness of the OTC derivatives markets. While the details of these efforts are far from clear at this time, it is likely that such reforms will – among other measures – include the following.

- Central clearing for all "standardized" derivatives between dealers and other market participants which, among other things, will pave the way toward substantially greater and more timely trade information and transparency.

- Non- standard OTC trades will be subject to enhanced capital requirements and trade information will be submitted to a so-called "trade repository" such as DTCC.
    - In this regard, it should be noted that as things stand today about 95 percent of electronically open CDS positions and many, if not most, non-standard and non-electronically matched positions are recorded in the DTCC "warehouse." Similar arrangements are underway or are planned for interest rate and equity derivatives.

- With regard to market surveillance in the credit derivatives space, DTCC now produces a weekly report on its website that provides gross notional, net notional and trade count information for most, if not all, reference entities including sovereign states. These developments, especially as they mature and as some standard trades shift to exchange traded instruments, will materially improve the scope, quality and timeliness of derivatives trade information. As a result, market monitoring and surveillance activities by regulators and others will be greatly enhanced.

- Finally, market makers and other major participants in OTC derivatives are likely to be subject to both more rigorous capital standards and more rigorous prudential supervision by their respective consolidated supervisors. Indeed, even now, prudential supervisors in virtually all countries have the authority to require trade information, exposure data and other relevant information from individual institutions as the supervisors see fit. In this regard, inquiries by supervisors that focus on subjects such as problems with collateral and/or margin calls may serve as an early warning of emerging problems.

These and other initiatives – together with the measures that have already been implemented – will constitute both the necessary and sufficient conditions to materially enhance the safety, soundness and transparency of the OTC derivatives markets. However, as we proceed with such reforms, great care must be exercised to insure that such markets continue to play their vital role in providing liquidity and price discovery in both the derivatives and the cash markets across a wide range of financial instruments that ultimately are central to the financial intermediation process generally.

Thank you.