LaSalle Street: Financial Markets Insights

The Podcast of the Financial Markets Group

at the Federal Reserve Bank of Chicago

Podcast 1 Transcript

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ALESSANDRO COCCO:
Welcome. This is LaSalle Street: Financial Markets Insights, the podcast of the Financial Markets Group at the Federal Reserve Bank of Chicago.

I'm Alessandro Cocco, and I lead the group. We specialize in research on central clearing, trade execution, financial technology and systemic stability.

We're very excited to launch LaSalle Street. This is a new way for us to share research and have an ongoing conversation about financial markets.

This fall we will release three episodes, and then we plan to come back in the winter with more.

In our first episode, Maggie Sklar, Senior Policy Advisor and Director of International Engagement at the Financial Markets Group, speaks with J. Christopher Giancarlo – Chairman Emeritus of the Commodity Futures Trading Commission.

Maggie and Chairman Giancarlo will talk about recent developments in the financial markets – central clearing and virtual currencies.

The next episode will focus on lessons learned during the Covid 19 crisis by Exchanges and Clearing Houses.

Our third podcast will cover developments in the Treasury Markets.

We are a part of the Research Department. The views expressed in this podcast are the speakers' own, and do not necessarily reflect the views of the Federal Reserve Bank of Chicago, or the Federal Reserve system.

Now I'll hand it over to Maggie.

MAGGIE SKLAR:

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I'm delighted to be here – virtually – with the Honorable J. Christopher Giancarlo, former Chairman of the U.S. Commodity Futures Trading Commission.

Welcome Chris, to the Chicago Federal Reserve's Financial Markets Group's first podcast. We usually hold a couple of conferences a year where we have the opportunity to hear from distinguished leaders and regulators in keynotes and fireside chats, but as we can't do those in person, we're trying to move on to a virtual format.

So thank you Chris for volunteering to be first.

After a distinguished career in law and business, Chris was Commissioner of the CFTC, appointed by President Obama, and the Chairman of the CFTC, appointed by President Trump.

Chris is now senior counsel at Willkie Farr & Gallagher, serves on a variety of boards, and is a co-founder of the Digital Dollar Project.

Thank you Chris, for being here today.

J. CHRISTOPHER GIANCARLO:
Maggie it's really great. It's great to be here, it's great to be with the Chicago Fed in this program, and it's good to be with you – we worked together so closely for so many years, it's nice to be reconnected in this virtual fashion.

MAGGIE SKLAR:
So one of the fascinating things, I think about your tenure at the CFTC, is that you chaired the agency with primary responsibility for supervising the derivatives markets – which includes the agricultural and energy products that people think about when they think of the CFTC, but your tenure also included attention to CCP's, to international issues and uniquely, a lot of focus on cryptocurrencies and Fintech – which we'll talk about as well.

But we're also coming up on a milestone here, in that it's been just a little over a year since you served as Chairman of the CFTC. Looking back, what can you share — some of your observations from your time there?

J. CHRISTOPHER GIANCARLO:
Well thanks Maggie. It's interesting, you go into a role like that for an agency that has a very important mission, and you are fortunate enough to be handed the reins and you go in with a set of objectives, and then life and events conspire to suddenly have you focused on things that perhaps you didn't expect.

And the challenge is to both handle the things that come up serendipitously while remaining focused on some of the core objectives that should go into the job. I certainly never expected cryptocurrency to play some of the role that it did during out time at the agency, nor did I expect

the amount of attention that was necessary to be devoted to international matters to impact our time at the Commission.

But they did, and I think part of leadership is being able to adjust and deal with things as they come up. And I think we were able to do that.

MAGGIE SKLAR:
One of the things that I noticed in working with you at the CFTC is that you're a prolific writer, and that you really enjoyed writing, so I know you're getting close to finishing your book – not sure how much you can discuss about that at this time – but what inspired you to write your book and to the extent you can, what are you writing about?

J. CHRISTOPHER GIANCARLO:
I've, you know, throughout the course of my life, always found writing to be a way of analyzing issues. I find that the way to explore an issue set or an area – whether it be an area of the law, an area of business, an area of policy is to write about it. And I write first for myself – to help explain it. And then I'll often write for others to help them see a perspective from the way I see it.

One of the important things that derivative markets do, that I think a lot of people may not understand, is in addition to serving as marketplaces for risk-transferred, risk hedging, derivative markets often in many cases serve as the primary place where the price is set for the derivatives but for the underlying cash markets themselves. And that's something that I think folks are not as familiar with – the role that derivative markets play in setting price. And that was very much an issue with the evolution of Bitcoin derivatives.

When commodities are traded in disparate markets around the world – cash commodities – then it's often the derivative market that provides the one place where all buyers and sellers can meet and therefore establish the price. And that's true in most of the world's important global commodities, that the price is not set in the stock market.

So the price for soybeans is not set at the elevator where farmers sell them, or not priced at the point-of-sale of large shipments of soybeans around the world, they're actually priced in the derivative market. The same is true about wheat and cotton and corn. The same is true about .. precious metals. The same is true about industrial metals. The same is true about energy supplies. And the same is true about most of the important benchmarks – whether they be interest rates or foreign exchange rates.

That's why derivative markets are particularly important, and it's a very big distinction between, say, equity markets – where the price is settled in the cash exchange. In derivative markets, the price of the underlying commodities is often set in the derivative markets.

And that's something that I – in my first white paper that I wrote as a Minority Commissioner of the CFTC, I used that white paper to explain that feature. And in my book, which I've just — I'm

very excited about because you mentioned that one-year mark. It was my goal to finish my manuscript by one year after my departure.

And the week before the anniversary came up, I was able to get the draft to my editor and we're now talking to several publishers and I'm hoping to have the book — my working target is to have it out by the time of the large annual FIA Conference that takes place every year in Boca Raton for the whole global derivative industry.

And my book talks about our time at the CFTC, but also focuses on a number of key issues that we dealt with from some of the international matters, but particularly having to do with derivatives on cryptocurrencies – which was a particularly unique time at the agency, and Maggie, you were there assisting me as we dealt with some of those very complex issues and I think readers will find some interesting stories in how we were able to deal with it during that time.

MAGGIE SKLAR:
Yeah, that sounds great. As you know, I'm really looking forward to reading it.

So staying with the markets, but turning to recent affairs, how do you think the derivatives markets have held up — or are holding up — during the crisis and the recent bouts of volatility and, you know, is there anything that surprised you or didn't surprise you as to how the markets or CCP have gone through this crisis?

J. CHRISTOPHER GIANCARLO:
Well it's been fascinating, right? You don't look forward to crises as a way of testing markets, but when they do happen, they do provide some very good bench-testing of both reforms that have been put in place, as well as the underlying health of markets.

And from what I've seen – I don't have access to the same data that we used to have when we were at the agency – but what I've seen, and from conversations I've had with market participants it does seem that the derivative markets overseen by the CFTC have held up very well. It does seem that the clearing houses have done a remarkable job ..

One clearing house senior executive said to me that Covid crisis was almost as if you had both a 9/11 and the 2008 financial crisis happen at the same time. It was both an exogenous – an external impact in the way that 9/11 was, but causing enormous strain on the financial institutions in the way that 2008 financial crisis was.

And yet the clearing houses held up remarkably well. And I think that is a testament to their work – they first and foremost should get credit for the work they've done – but also a credit to the reformers that helped put in place the reforms of Dodd-Frank.

Now we've also, though, seen some disruption. It must be somewhat disappointing that for 2 key markets – the repo market and the commercial paper market – that the Federal Reserve had to

step in and provide some liquidity support. The classic definition of a central bank is a lender of last resort in a crisis.

I don't think anybody ever intended the role of a central bank to be a liquidity provider of last resort into markets, and yet we saw that. And so that does raise the question as to whether some of the capital rules not by the CFTC, but by bank regulators – both domestically and internationally – have hindered the ability of large financial institutions to provide market liquidity.

And certainly we've seen concentration of market-making liquidity amongst larger banks. That's a sort of a 10-year trend – the trend toward banking consolidation – but that is a concern and so I think coming out of this crisis is both good news in the resiliency of the clearing houses and some of our major financial institutions, but there's also I think some areas that need to be reviewed as to whether we've seen evidence of capital concentration and capital constraint.

And, you know, I've repeatedly said during my tenure, Maggie, and you're very familiar with this, I said we need to ask the question again and again whether in solving for balance sheet risk of our major financial institutions – that is, their own balance sheet liquidity – we've created a fortress balance-sheet mentality and as a result, have harmed their ability to put liquidity into markets during times of stress.

You know, risk is like a giant balloon – if you squeeze it in one place, risk pops out in another. And perhaps in – but you're seeing the balance sheets of financial institutions we've actually hindered their ability to put liquidity in the market during market crisis. And so we may have traded bankruptcy risk for perhaps a market risk. And we do need to examine that as we go forward.

MAGGIE SKLAR:
That's an interesting point. And I like the balloon analogy – I'm always looking for analogies that make sense and relevance and that are explainable to people as you know, the derivatives markets are complicated and often people point to *Trading Places* as the example. But as we know, the markets are more complicated and sophisticated, certainly, than just that movie.

So staying with clearing houses, given their importance post-financial crisis and their role of respective financial stability, you chaired the CFTC which supervises the futures and Swap CCPs, so, you know, how do you see CCP's provisions from a marketplace perspective; and to the extent you, you know, have thoughts on this as well, you know, how does that differ, perhaps — or not differ — from how prudential regulators look at CCPs?

J. CHRISTOPHER GIANCARLO:
Oh, that's a great question. You know, market regulators and prudential regulators are different facets, you know, of the same gemstone. We see it from a different perspective. The resolution of clearing houses is very different than the resolution of banks and other financial institutions.

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You know, banks and financial institutions .. prosper and thrive on taking risk. That's their business model. They have to put depositors' money to work and in so doing, they take risk. Now, those risks need to be calculated, they need to be controlled, they need to be hedged, but nevertheless, their mission is to take smart risk.

Clearing houses should not take risk. They are not designed to take risk. They are designed to be risk-neutral. If they are taking risks, they are failing. They are failing their mission. Their mission is to mitigate risk and is to be risk-neutral. It is their members that take risk, and use their clearing to help mitigate it, but ultimately the members are the ones taking risk.

And therefore, tools – whether it be resolution or supervision – that apply to a financial institution and their risk-taking activities are inapplicable to clearing houses whose very structure and design is to be risk-neutral and to not take risk. And so that is a difference.

Another difference is that regulators around the world have different approaches to clearing house supervision. And, you know, there has probably been no administration of the CFTC that was more committed to working in international bodies than I believe ours was. I mean, we participated directly – I either chaired or co-chaired a half-a-dozen different international work streams during my time at the CFTC – everything from market fragmentation to market resiliency to cybersecurity to international data standards ..

So we were very committed to the international standard-setting body process. But at the same time, the world's marketplaces are very different. The United States financial markets are very different than the European ones, and the European ones are very different from the Asian ones. And there is no one-size-fits-all approach.

I mention the Europeans' approach to clearing houses and supervision. The Europeans have a notion of the official sector's ability to supervise how collateral is treated in a clearing house. Whereas in the United States, we believe it is actually detrimental to the workings of a clearing house if regulators were to step in and make collateral valuation decisions, or to instruct on that. We view it as counterproductive.

And so one of the .. despite being very, very active at the international level, I always felt it was critically important to remind global standard setters that our markets are different and therefore there needed to be different regulatory responses customized for the difference in those marketplaces. And that certainly was an issue when it came to clearing house supervision.

As you know, as a result of Brexit — but actually even before Brexit — the EU was very concerned about collateral management by the London clearing house, certainly having to do with Euro-denominated sovereign bonds issued by Spain and Italy. And presumed that the official sector should have insight into how what's known as "hair-cutting" – how hair-cutting was done by the clearing house having to do with Euro-denominated instruments.

Now in the United States, the notion that the CFTC would step into a clearing house and tell them whether or not to discount dollar-denominated debt would just be an anathema. We view that as counterproductive. We view that as giving the world that uses our markets reason to doubt an objective treatment of collateral. And so therefore, the U.S. approach is a complete hands-off to that.

Obviously we review margin models, obviously we review standards – but we don't take individual views on individual collateral. Whereas the EU does. And, oh, that's fine – and I'm not criticizing that approach. I may believe it would be counterproductive to the dollar, but I'll let our European friends decide whether it's counterproductive to the Euro and to their markets.

The point is, however, we come at this from different points of view. And so therefore I was always very concerned that international standards-setting bodies would try to take a one-size-fits-all approach to this. And because often these bodies are dominated by our European friends, I'm very concerned that U.S. concerns that are unique to U.S. markets be reflected in those standards-setting.

You know, our markets – our economy — on a retail level, may be equivalent to Europe. But when it comes to wholesale markets .. I mean, really, there is nothing equivalent to the United States. Its depth and breadth is just an order of magnitude larger than any other marketplace in the world.

It is where the world comes to price its risk. And therefore, our market approach needs to be of a global standard at a very high level. And while, again, I'll return to the fact that I'm very respectful and engaged in international standards-setting, they can't be used to compromise practices that we pursue in the United States that go back centuries.

I mean, we have had .. our Chicago markets go back to the mid-19th century. And practices that have worked for a long, long time and made these markets the world standard can't be compromised in some rule-writing by some global standards-setting body that's more responsive to conditions outside the U.S. than they are responsive to conditions inside the United States.

So as chairman of CFTC you're always facing this balance between respect and participation and international bodies, and yet standing up for the uniqueness of U.S. markets and U.S. market experience.

MAGGIE SKLAR:
So these – you know, as you were talking about the international perspective as well, you recently published an Op-ed in *Risk* about the FSB's proposed guidance on CCP resolution and the treatment of CCP equity and resolution.

I was wondering if you had further thoughts since that was published maybe, or maybe things you can share about conversations or discussions, or where you think that maybe this leads or goes or how it affects U.S. CCPs if the guidance goes forward as currently written.

<u>J. CHRISTOPHER GIANCARLO</u>:
Yeah. Thank you for that. Yes, I did publish a piece in the International Financial Law Review recently in response to a work stream being done by the financial stability board that is looking at the manner and principles related to the stage of clearing house – the lifecycle of a clearing house – which is the final stage of that which is known as resolution: when the clearing house failure is deemed to be systemic, and the clearing house needs to be wound down.

And FSB is approaching that with the notion – or at least in their proposal, or establishing a principle – that the CCP's equity holders should bear all the risk of a resolution. And my concern there goes back to the original analogy I pointed out that risk is like a balloon. If you squeeze it in one part, you're going to have risk come out in another.

And by the FSB taking a singular view at resolution, and not the earlier stages of what's known as resiliency and recovery, they are gonna change the incentive structure <u>for</u> those earlier stages and yet act as if they can be treated separately by some other body somewhere.

So they were going to squeeze the balloon at one end, and actually not be cognizant – or at least not <u>assume</u> responsibility – for what happens in the other stages. And I just felt that was unrealistic.

You know at the end of the day, the FSB is made up <u>mostly</u> of central bankers and finance ministries and is heavily European-dominated. It <u>doesn't</u> include the CFTC — the regulator of the world's most important clearing houses. And there's really nobody there to fully explain – you can't just take one piece of what's a holistic set of risks and tinker with it and walk away saying, "Well we're not gonna assume it's having any impact on the rest."

Any tinkering with the risk incentives of a clearing house needs to be done first and foremost by the overseers who were responsible for the outcome – which in the case of the United States would be the CFTC and the FDIC. Neither of which are members of the FSB process.

And so my argument was not whether or not the FSB's approach was right or wrong, my argument was they are the wrong body to be tinkering. If there's tinkering to be done a) it should be done by the overseers of the world's most important clearing houses – which are, with great respect to my European friends, are either American or British – and secondly, you need the bodies that are responsible for the outcome. If things go wrong, who's responsible? Not the FSB – it's not a regulatory body, it's a standards-setting <u>advisory</u> body.

And I have a <u>great</u> deal of respect for the FSB; I do feel strongly it was a mistake of the Obama administration not to put the CFTC <u>on</u> it — and I think it hinders the FSB's authority to speak about matters of derivatives. But be that as it may, that choice was made and hopefully a future administration will remedy that.

But it does go to the question of whether the FSB is really competent to be tinkering with one part of the clearing house lifecycle and yet not responsible for the outcome. And I feel that any work in this area needs to be holistic, it needs to look at the entire lifecycle from resiliency to recovery to resolution, and it needs to be done by agencies that have the decades — centuries — of experience in looking at that, and that's what we've got in the United States.

MAGGIE SKLAR:
Thank you. You know, one of the other things that you mentioned too, as you were talking as well about CCPs, was Brexit. I know this was one of the areas you put a lot of time and leadership into at the CFTC with respect to the potential impact on clearing houses and the derivatives markets. I was wondering, do you have any thoughts as we sort of head towards the end of the Brexit transition period?

J. CHRISTOPHER GIANCARLO:
Well you know that's a perfect example of the kind of thing I said at the outset. You know, you step into a job focused on, you know, in my case I just focused on a lot of domestic issues and yet international affairs changes that.

The Brexit decision was a decision entirely within the choice of the UK population to make, but having made it, it had an enormous impact. For one thing it rekindled a battle between Brussels and London over clearing, as I mentioned before, on behalf of European – and by that I mean EU member firms — and it had also clearing of instruments that are denominated in the Euro.

And as I said going back to some crises in 2012 and 2013 having to do with Italian and Spanish bonds, our friends in Brussels felt that any choice about collateral management by the London clearing house needed to have a political input into it. And that's a point of view and that's a policy choice that's different than the approach we take in the United States. And therefore a battle began over the handling, the oversight, and at one point the actually siting where that clearing needed to take place.

And the EU position was unless they had the supervision they wanted, it would have to take place within the Euro zone.

Now, I'd never wish to get into a battle over something resulting from Brexit as I said repeatedly, and always repeated, you know, "We take no view on what's effectively a European-wide question. It's not for the U.S. to take sides in this."

However, the London clearing houses – most of the capital comes from American banks. Most of the trading activity is by American firms. And the CFTC is not a secondary, but is actually a direct regulator of the London clearing house going back almost 2 decades.

And so we were drawn into this issue because we had to protect U.S. interest — U.S. banking interest – but as well as U.S. capital – and a direct registrar on the London clearing house with the CFTC.

And there was a lot of brinksmanship going on, and at one point it reached the potential where the London clearing house, pursuant to its own rule book, was going to have to actually fire – disengage from – key clearing members because of the impact of what they called a "hard Brexit".

And it could have caused a real market crisis. And we became very vocal – I became very vocal, both directly and through a U.S. administration to let capitals on both sides of the channel know that U.S. interests were directly involved. Their brinksmanship was perhaps the cause of a major market crisis and cooler heads needed to prevail and the brinkmanship needed to end and a sensible resolution needed to be brought about.

I'm afraid that was just a temporary pause because from what I read in the paper, negotiations are not proceeding that well between the UK and the EU over financial services, and once again there's some concern as to the clearing taking place at the London clearing house.

Again, I'm not as close to this as I once was as a Chairman, I don't want to overstate this, but I do get the sense that some of the same issues are back at hand, and that's really a shame.
You know, I .. last point I'll make on this is: I don't really think it's in Europe – and by that I don't mean the EU, I just mean the continent of Europe – to be bloody-minded when it comes to the role of London.

Every geographical economic zone needs a financial capital. The United States has New York and Asia has Hong Kong and several of them. Europe has Britain and has had Britain for decades now. Once you get away from Britain, the nearest European financial capital in international rankings of finance is almost like number 30.

It's not like breaking down London is suddenly going to emerge Frankfort or Dublin into the top 5 of financial centers. And without a financial capital it's going to be hard for European companies to raise capital from global investors.

And so I think the EU, you know, while it's pursuing an industrial policy of trying to move more financial business into the Euro zone – and that's fine – if all it does is harm London and spread capital around 5 different centers – so instead of having one city that's in the top 5, it's got 5 cities in the top 25, I don't think it's served European commercial interests. I don't think that serves the purpose of European manufacturers and industrial firms that need to raise capital — whether it be equity capital or debt capital – in truly global markets.

They may be able to raise in local markets but it's going to be really hard to attract global capital to offerings by European firms if all that results from this is the diminishment of London and the marginal increase of global capital attraction of 4 or 5 different European cities.

I think it would be not in the long-term interest of Europe to do this, and I think there needs to be thoughtfulness about this and there's got to be a way for London to continue to serve the EU and

the EU to continue to do business in London in a way that's good for everybody without too much destruction of the ability to raise global capital into a financial center.

MAGGIE SKLAR:
Changing the topic a bit, but to also a topic I know you were very familiar with — to benchmarks.

While you were Chairman, you and the CFTC were active in the discussion around, and the transition from Libor. Currently you are on the board of AFX which offers the Ameribor benchmark.

Can you talk a bit about what Ameribor is, how it fits into the transition and what are you finding distinguishes it, or its client base, from the other alternatives which include Sofr. And then if you can also maybe talk to — if you know about — the benchmark proposed by Tradeweb and ICE — and how it compares.

J. CHRISTOPHER GIANCARLO:
Yeah, so thank you for that. So, you know, Libor's a topic I know quite well going back to my days on Wall Street, building some of the first electronic trading platforms for over-the-counter credit default swaps and also being a student of the interest rates swaps market and knowing that quite well.

And the story of Libor is a fascinating one because to some degree it came about because of restrictions during the Ford administration and the Carter administration that limited the amount of interest rate—interest that American banks can pay on foreign deposits.

And that's actually what caused a lot of those deposits to move offshore in London and elsewhere, where holders of capital could get a true market rate of return on their money, not capped artificially as they were in U.S. markets.

And that build-up of capital became the source of overnight lending at a time when major money center banks actually funded their daytime operations by overnight lending to one another.

But over the next several decades, as the large banks – especially those that were Treasury dealers – held large amounts of Treasury securities. They found that they could fund their operations in the Treasury repo market. And the Libor underlying overnight marketplace actually became almost a nonexistent market. The last time I looked at it when I was at the CFTC, there were less than a dozen trades per day in 30-day Libor.

So the market had diminished, but it also not only diminished in depth – and this is a very important point. It not only diminished in depth, it diminished in breadth.

You know, at the CFTC, when we look at markets to determine their quality, we don't just look at depth, we look at breadth. And breadth was a problem. You really got down to just a handful of

banks that were actually engaged in the Libor market, or as it eventually became, a call-around market, an estimated, educated guess market.

And the combination of lack of depth and lack of breadth I think had something to do with the scandals that emerged before and after the financial crisis when banks were misquoting Libor.

I also remember that at that point, ARRC was being convened to consider alternatives and it was never the purpose to only go to one alternative. You know, the fact that Libor was such a dominant benchmark is actually kind of an anomaly.

If you look at almost every other asset class — those regulated by the SEC, say, in the equities area — you know you've got the Russell, you've got the Dow Jones, you've got the S&P, you have so many different benchmarks in the equity markets, you may have as many benchmarks as you actually have individual stocks.

Well certainly at the CFTC, the same is true. In energy for example, you've got WTI, you've got Brent crude, you've got a Shanghai rate. There's a Dubai rate. So many of the commodities overseen by the CFTC – you have a multiplicity of benchmarks that are appropriate for the different exposure to that asset class that market participants wish to take.

And so to think that in a replacement for Libor, we'd go from one benchmark to one benchmark, doesn't really make a lot of sense. I mean, in a market as sophisticated as the U.S. fixed income market, why would we agree to have one benchmark?

And then secondarily, if the problem with Libor is a lack of depth and a lack of breadth, well certainly Treasury repo, which is what Sofr is based upon – it's based upon a very deep market – but it's no more broad than was Libor. It has the same issue of concentration of market participants that does Libor.

And so one of the benefits of Ameribor, is the breadth of its market. It has close to 200 members acting on behalf of over 1400 market participants operating in the market. There's very little concentration of liquidity formation in the Ameribor market.

But at the same time, Ameribor is quite complementary to Sofr, because Sofr is a risk-free rate. It's based basically on Treasury securities, which are deemed to be as close to risk-free as you can get. And that's fine.

Ameribor is the opposite. Ameribor is an unsecured market, and so it's credit weighted. Now both of these serve – as I was just saying – benchmarks should be appropriate and properly tailored to the need of market participants.

A risk-free rate will serve many, many institutions, and I think Sofr is a very good choice for many institutions in the marketplace that can use the repo market to support their operations, and

therefore they'll have little basis between their cost of capital and the benchmark by which they lend capital.

But on the other hand, many institutions – especially smaller institutions and non-Treasury dealer banking institutions – can't rely on the repo market to fund their operations; they need to look to benchmarks that are based upon the risks they take in lending, which is unsecured risk.

You know, the lenders to the real economy of home builders, auto dealerships, small manufacturers – they're not hedging that risk with Treasuries. They're taking back collateral in the form of auto loans, in the form of home mortgages, in the form of plant and equipment liens; and they've got real unsecured risk in their lending activity and so therefore they're interested in a benchmark that reflects similarly unsecured.

So it's about diversity. Richard Sandor, the founder of American Financial Exchange, is a world-renowned economist and, you know, he says that economists don't agree on much, but the one thing they can agree on is that diversity provides market resiliency.

And that's why we view Ameribor as a very good complement to Sofr, not – it's a replacement for Libor, but it's a complement to Sofr.

To your last point about the new instrument that the ICE benchmark administration's unveiled – it looks like it addresses a number of the issues that people have been concerned with Sofr. But my understanding is it's still a risk-free rate. So it still has – it may be an improved Sofr, but I don't think it really is similar to Ameribor, and it really doesn't address the issues that Ameribor tries to address – which is really benchmark based upon unsecured lending, and therefore credit-weighted lending.

And from what I've read, most of the concern that's been raised about Sofr has been about the risk-free component and how can a credit spread or a credit structure be included. And so I think – I'm very excited about Ameribor. I think it will play a helpful role as we move away from Libor; I worked with the ARRC committee during my time on the Commission; I know its choice of Sofr was well-considered — there was a lot of debate ..

And I think Sofr's going to play a big role — in some form of Sofr, maybe with these improvements that ICE has added to it — will play a big role and serve very well for those institutions that fund their operations based on Treasury securities. But I don't think it answers every need in the economy.

The U.S. mortgage market is the world's deepest, biggest – and a market as sophisticated like that deserves the sophistication that comes with choice of benchmark and the ability to have the market diversity and the market resilience that comes with choice, with variation and with different instruments based upon different lending profiles and different funding profiles.

MAGGIE SKLAR:

Good, thanks for that. So turning to the last, but certainly not least topic I'd like to talk to you about, is virtual currency and stable coins. You know, as Chairman you were active in bringing cryptocurrency to the forefront to the U.S. financial regulatory world's attention; and testified before Congress, where you earned the nickname "Crypto Dad", as well as becoming the face of some internet memes..

I remember that well, because that was my first time ever **[LAUGHING]** being in a meme, as I wound up in some of them with you. **[GIANCARLO: Yeah.]** That was an interesting experience, and as you know, there were many memes going around. **[GIANCARLO: Yeah.]**

With respect to stable coins in particular, you know, you've spent a lot of your time now after the CFTC engaging – and leading – in this area as founder of the Digital Dollar Foundation, which is, you know, working to advocate for the exploration of the digital dollar.

How did you get interested in stable coins in particular, and actually I should ask you if there is a difference between my use of stable coins or digital dollars as well.

<u>J. CHRISTOPHER GIANCARLO</u>:
Sure. Okay, so the whole Crypto Dad thing was funny, you know — I went to a Senate hearing in February of 2018 and I think, you know, up to that point I had a little over a thousand followers on Twitter. To this day I still manage my own account, I don't use any outside services – and I walked out of that hearing and within 48 hours had 46,000 followers on Twitter.

And it was something I never anticipated; I simply went to that hearing and put down my prepared remarks and looked the senators in the eye and said, "Look, there's something going on here in terms of the next generation's enthusiasm for cryptocurrency, and I think we owe it to them to treat it with respect and not disdain, and let's try to get this right and really be thoughtful about it."

And the words I used may have been a little more artful than that, but it just exploded on Twitter, and I was awarded this name, Crypto Dad. And I realize that the Crypto Dad thing, while it's fun and it's good for a laugh, it also gives me a way to speak to these issues with some degree that people pay some degree of attention to. And so that I think that's useful.

And what are these issues? Well – and this isn't coming from me, this comes from a Deputy Governor of the Bank of England, Jon Cunliffe – a very thoughtful person who I've had the pleasure to get to know over the last few years. And he said to me, he says, "You know, Chris, it seems like once every few generations, once every century, people stop and say — and ask the question – what is money?" And he said, "I think we're asking that question all over again."

And I think he's really right. I think the combination of the fact that tokenized money hasn't really been addressed in this country for over a hundred years, we haven't done much with our currency, combined with the fact that we're going through a new wave of the internet — some people call it the internet of value.

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When things of value – and that could be from soybeans to financial contracts – are going to be digitized, decentralized, and increasingly programmable. And that's what's going on right now. A generation or two below me – my kids' generation – are re-looking at money and experimenting with it. And this experimentation is going on.

You know, in history sovereigns haven't always controlled money. Money is sometimes societal. Money is sometimes commercial. The notion that a central bank has a lock on all money creation is kind of a modern notion and it's not really true.

And we're seeing it again. We're seeing experimentation going on with money <u>outside</u> the official sector, and the official sector is coming to it now and in some cases actually ramping up. But they're playing catch-up, because this actually started 10 years ago with Bitcoin and it accelerated with Libra Coin.

And the proliferation of stable coins is really moving very rapidly. And the official sector's in a game of catch-up to what's going on.

Society has decided to re-look at money in the light of new technologies. And in some cases I think the official sector is gonna be left behind. The genie is out of the bottle; I said in a Tweet recently, the cat's out of the bag. And I really think that the official sector needs to wake up to what's happening.

In the future, things of value are going to be digital and programmable. And people are going to look to program them into money directly. And if the money is not programmable, they will go to another instrument that is. And I think the Chinese have figured that out.

And you know the technological capability of money has historically been one of the reasons why people in commerce might choose one instrument over another. You know, during the period of the European exploration of the eastern coast of North and South America, there were many currencies in use. There were Dutch guilders, there were French francs.

The currency, though, that seemed to have an edge on the others was the dollar. But it wasn't the American dollar. It was the Spanish dollar. And the reason why it was the most preferable was because it had certain technological superiority to the others.

For one, it was minted with New World silver, which was superior to Old World silver in that it needed less alloy, it was lighter, and it was more consistently pure. But the second element was that it was minted in such a way that it can be broken up into 8 equal pieces – known as Pieces of Eight. And that allowed it to be fractionalized, and therefore more use in smaller retail commerce.

And those are 2 technical capabilities that drove, in the world back then, their preference to using that currency.

Now let's fast-forward to today. As important as the dollar is – and it is you know, it is without a question now the world's premiere reserve currency and is likely to be so for a long time — and there's many pillars underpinning that.

But at the same time, if you imagine a future where a currency other than the dollar is programmable, it is digitizable, it is tokenized – and the dollar remains an analog instrument, accounts based primarily only for international transactions, is it not possible that the dollar could suffer in comparison?

I believe it is. And therefore I believe this is not a defensive strategy it's an offensive strategy. We should do everything possible as Americans – especially as the official sector in the United States – to modernize the dollar, to stay ahead of the times, to prepare it for this new digital future.

Do we really want to be the purveyors of an analog culture if suddenly the world says that they need — I said, of an analog culture, I meant an analog currency — if the world decides that they need a programmable currency to account for all the important things that today are accounted for in dollars?

You know, I was very proud to be the Chairman of the CFTC which oversees the markets, and I began the conversation with talking about markets, where the world's things of value were priced – from soybeans to oil to foreign exchange and interest rates.

Well, if all those things go to a digital programmable format, will they still want to count for them and price them in dollars if the dollar remains an analog instrument? Or will the world look for a digital instrument that they convert those digital units of value in the future into?

And I think we need to think — we need to take our eyes off just what's right in front of us in the highway and look at the horizon and see where things are going, and think about how do we future-proof the dollar today for that digital tomorrow.

And I think China's doing that, I know that the Bank of England is looking seriously at this, the Bank for International Settlements is, France is looking at this – a lot of the world has got big efforts going on looking at this. And we need to do that in the United States.

And that's why we formed the Digital – I formed .. this is a not-for-profit – at the beginning of the year, I called it the Digital Dollar Foundation, with contributions from my brother, who's a renowned Silicon Valley entrepreneur, and Daniel Gorfine, my former Chief Innovation Officer at the CFTC – our former Chief Innovation Officer.

And we formed the Digital Dollar Foundation and then we teamed up Accenture on a pro bono basis in the Digital Dollar project.

And our goal is really to advocate for the U.S. to move beyond a casual glance at this to a determined and thoughtful look at this, and doing that for a series of pilot programs as the United States has always done big things – whether it be the space program and the internet.

It's always been partnerships between the private sector and the public sector and we're advocating for the same thing for the U.S. to look at a central bank digital currency that would be tokenized, distributed through the existing 2-tier banking system.

So we're not looking for something that bypasses the banks, nor are we calling for retail Fed banking either.

We're saying that a tokenized instrument can provide lots of means for financial inclusion, to address issues of underbanked populations, but through an existing infrastructure we have in place today. Would be minted a lot as cash is done today – that is, produced, either on behalf or directly by the Federal Reserve, distributed through the banking system in return for deposits and then onward distributed into the broader economy.

So that's what we're doing with this, it's a project that's near and dear to my heart. It's something I'm doing as what I believe is a public service, a way of giving back. I really believe that the U.S. can't shut its eyes to this.

And whether one is inclined to do it as a defensive measure, or I think more importantly as an offensive measure, just – we have to ask ourselves: If everything is going to a digital format, why would we not do the same for our dollar? Why would we not modernize our dollar? So it can continue to serve what I think has been a beneficial role for the most part since the end of the Second World War as the world's reserve currency.

You know, the values that are built into the dollar. The values of free enterprise, the values of rights of privacy properly balanced against the state's interest in law enforcement. The rights of freedom of expression. The rights of free market economics built into the dollar.

I think had been a major reason why in the last 80 years we've seen a global economy emerge – a truly global economy – and with it, rising living standards for billions of people around the world have happened during the dollar's watch as the world's leading reserve currency.

And I think that extending that into the future is in the interest of the United States, but also the rest of the world. And I think we do that by modernizing the dollar alongside the modernization of the modern economy.

MAGGIE SKLAR:
You may have already just answered this in what you were discussing, but you know as you mention coins and commerce, as I'm sure you know there's currently a coin shortage caused by the Covid 19 pandemic. The Federal Reserve has convened a coin task force.

You know, would broader adoption or use of stable coins or digital currency have led to a different situation than what we're seeing right now with having to try to figure out how to get more coins in circulation?

J. CHRISTOPHER GIANCARLO:
Well, so that's a fascinating question because what do coins – what purpose do coins serve? Coins serve the purpose of making change. That's really what they're there for. So in purchases, the need to make change.

But if you can develop a digital dollar that's truly fractionizable to any pennies and below, then you wouldn't have the need to make change anymore. You can make payment in the exact amount, exact payment required for a purchase at any fractional level up or down.

And so therefore for the need for coinage would go away and now we still may create coins for collectors and otherwise, but the need for them – which we're suffering now – would not be there. And with that would go any degree of coronavirus transmission that takes place through coinage or paper money.

And so I think you solve both the coin problem and the virus transmission problem at the same time if we're able to create a U.S. CBDC.

MAGGIE SKLAR:
Can you also just expand a little bit on, you know, there's varying models as you know as to how to proceed with, you know, this being a private or central bank or sort of a quasi-public / private initiative.

What models specifically are you looking at, and advocating?

J. CHRISTOPHER GIANCARLO:
So I think there's a spectrum of views on this. On one end of the spectrum there may be the belief that something like this can be created entirely in the private sector and it just needs a blessing from the official sector.

Then, I think on the other end of the spectrum is the view that the money is inherently and entirely a central bank prerogative and therefore there's no need for the private sector involvement – and the private sector can't be trusted in something as important as this.

Mine is a middle view. One is that it absolutely must involve the official sector, the central bank, because after all it is a central bank liability, and the central bank needs to be involved in every core policy decision – as does Congress, quite frankly. As does both the Executive and the Legislative branch of government.

And the policy choices are significant enough, they go beyond money to issues of rights of privacy, to other constitutional issues. And so therefore I think you need a broad spectrum of the private sector involved in this from the beginning to the end and throughout.

On the other hand, to say that it's so important that it can only be done by the private sector actually flies in the face of history.

The public sector has always been involved in currency throughout history. You know, the Bank of England hasn't always been a central bank – it was a private bank for a long time — and yet it was involved in money creation in the UK.

And similarly in the United States, the ascendancy of the central bank into American money really only happened in the late 19th century, and we've had private actors in this.

And it also – that notion that the private sector has got to be playing the singular role flies in the face of how we've done big technology experiments in the United States.

You know, when President Kennedy said we were going to land a man on the moon, the United States government saw that as a national purpose. And yet, what did it do? It turned to the private sector to build those rockets and to build those space capsules and to build those launching pads.

The private sector was involved in the exploration of space for the United States from the beginning. And it's the private sector that is carrying that torch today in the form of SpaceX.

And similarly, in terms of building the internet, the United States government – the Department of Defense – had a huge role in getting it started. But the internet, we'd still be waiting for Uber and other services to come along today if this had remained in the hands of the government.

And the fact of the matter is, to be brutally honest? The federal government hasn't had a real good track record in initiatives that it tries to do on its own. I mean just, you know, the healthcare.gov is not exactly a shining example of government competency in technology innovation.

And at heart, a digital dollar is a big technology lift. So I think the middle ground of this debate is that the right thing for the United States to do is a public / private partnership.

Look, even China – which is a communist government – is involving — I don't know, it's hard to know in China where the public sector ends and the private sector begins, but they're involving their equivalent of Uber and online retailers in their development of a digital yuan.

If it's good enough for a, you know, a state-controlled economy to look to the private sector, well it's certainly got to be good enough for an open economy – an economy of free enterprise, a

capital markets economy like the United States — to not try to see this as official sector only, private sector not apply.

So I think the middle ground is this certainly in my conversations on Capitol Hill there's a respect for the notion of public / private partnerships, and I actually think that is – that's the American way of doing things. And I think that will be the American way of building a digital dollar.

MAGGIE SKLAR:
Thanks. You know, before we wrap up, one of the things, you know, you're known for is as you know, from when you were at the CFTC, was writing a letter to the Vatican back in 2018 explaining the benefit of credit default swaps.

So I have to ask: have you considered – or do you have plans – to send a letter explaining your views of the benefits of digital dollars?

J. CHRISTOPHER GIANCARLO:
That turned out to be one of the nicest experiences I had, of many nice experiences.

The Vatican wrote, I thought, a very thoughtful paper – what they call a bollettino — on modern finance and it was only a small part that actually talked about derivatives, but I felt after reading it they had gotten a few things wrong, and I remember thinking to myself, "Somebody should respond to this letter," or this struck me that, as a Catholic, and as a head of a regulatory agency overseeing derivatives, that probably I was one of those people that should write back and so I did.

I teamed up with Bruce Tuckman, who is the CFTC's Chief Economist, and we made the case for derivatives as actually being quite important to the population of — the world's underserved and marginalized populations that the Vatican is concerned about. That, but for derivatives, they would suffer terribly from squeezes and shortages and hoarding of key commodities like bread and others but for the presence of derivatives.

And the reason why I say it was one of the nicest experiences, that we wrote that letter – I think we made a point of saying that we're really writing in the search for truth and the search for goodwill and conversation.

And the response I got from the Vatican mirrored that. I had the pleasure to be invited by the Vatican to visit last fall, in 2019, I went to Rome, I went to Milan — to Catholic University of Milan — and debated this with Cardinal Turkson who is the author of the Vatican's bulletin.

And for those who watch Vatican politics, he had been the runner-up to the current pope – to Pope Benedict – to be Pope last time. He's a fascinating man. I think one of 11 children of an African family. And we continued our dialogue in Milan on this topic.

And I've been able to keep a dialogue with the Vatican on issues of this and many others which they're interested in. And I hope it becomes a lifelong correspondence that I can continue to mean with them – all in a search for the truth of modern markets.

You know, they're easy to denigrate, and yet the presence of food on our shelves day in, day out – weather conditions notwithstanding – is proof that derivative markets serve society and serve society well to prevent shortages and hoarding and other things that happen in markets where derivatives are not present.

And I think if anything, I've helped the Vatican better understand the role that derivative markets play in modern markets. I think they've helped me understand better some of the concerns of other sectors of society that don't understand or are concerned about financial engineering and the problems it can cause.

And so I hope I'm better — a better person for that dialogue with the Vatican, and hope to continue it for a long time to come.

MAGGIE SKLAR:
Thank you. So to conclude, I just wanted to know whether, looking ahead, is there anything you see in the horizon, from your experience in the markets that regulators, policy makers, central bankers – that we should be looking out for?

J. CHRISTOPHER GIANCARLO:
One of the things that the Covid crisis has shown us is the shortcomings in our accounts-based system that is in some ways so ingrained into our thinking about money that we take it for granted as if it is an unchanging structure.

And while we might acknowledge the shortcomings of the SWIFT system or payment rails, we may – I think – mistakenly believe that the answer is to just make them faster, perhaps more efficient. And yet there is truly a major disruptive technology on the horizon that could make that old technology obsolete before there's even time to upgrade it.

And I think we need to both be focused on the shortcomings and the patches we can do, but we need to be thinking about the ramifications of distributed ledger technology and this new wave of the internet of information.

The internet has changed so much in the way information is done. I grew up in the 1960s and 70s – the final word on any intellectual issue was contained in something called Encyclopedia Britannica. It was the authority on so many issues. And yet that is completely wiped away. And the process of building authority is based upon a consensus model as opposed to a acknowledged expert model.

It's a completely different model. And it's changed the way my children look for authority in any given issue.

I'm here to tell you now, that the nature of things of value, and how they're transported around the globe, is gonna go through the same profound change. It's so easy now to send a photograph or an MP3 file of music that you can send in instantaneously. And yet it still takes days, if not weeks to move money around the globe.

That is gonna be unacceptable to the next generation. They're gonna want to move money and things of value in the same instantaneous message that they can do Snapchat. And that won't work on an accounts based system.

Accounts based system is gonna be under serious threat. And we can either try to shore it up or we can try to get ahead of the curve and think about what's coming. But what's coming is coming. Technology is like a mighty wind, you cannot withstand it.

You can either harness it and put a sail on it and ride it, or you can get blown over by it. But you're not gonna change the wind. And that's what's happening in things of value in this market.

And as a market regulator over the pricing of some of those things of value, I really saw it coming, and I think we saw it early. But it's gonna blow harder and harder in the decade to come.

And I really caution people listening to this podcast to think about how do we harness it for the good of all, and to harness in a way that incorporates our longstanding values of free markets against others who would harness it for state surveillance, for limitation of press freedoms, of rights of privacy, and of freedom of speech as we're seeing in some parts of Asia right now.

This technology can be used for good or for bad. Let's make a decision to use it for good and to harness it for ourselves and for our children.

MAGGIE SKLAR:
Thank you. Those are all really interesting thoughts. Personally, I miss my Encyclopedia Britannica, but I understand, yes. Yes, it's a – where do you find information now? And how are you sourcing it?

Those are all really good points. And, you know, interesting to think about how that transformation, as you say, will affect how people expect money and currency to move as well.

I just wanted to say thank you again so much, Chris. You had some thoughtful comments — and for taking the time and helping us do our sort of inaugural foray into, I guess, into this technology and trying to bring, you know, our conferences and experiences out there virtually.

[MUSIC UNDER.] So thank you for that.

J. CHRISTOPHER GIANCARLO:

My pleasure, Maggie. It's really good to spend an hour – the last time I spent an hour with you was a year ago. So it's nice to spend time together.

MAGGIE SKLAR:
[LAUGHS] Well, I hope you and your family and your colleagues stay safe and healthy. And, you know, I want to say to everyone listening, you know, thank you for listening to this event.

J. CHRISTOPHER GIANCARLO:
Thanks everybody.

[MUSIC UP FULL TO CONCLUSION]