ViewPoint: Reducing Risk in the Global Financial System

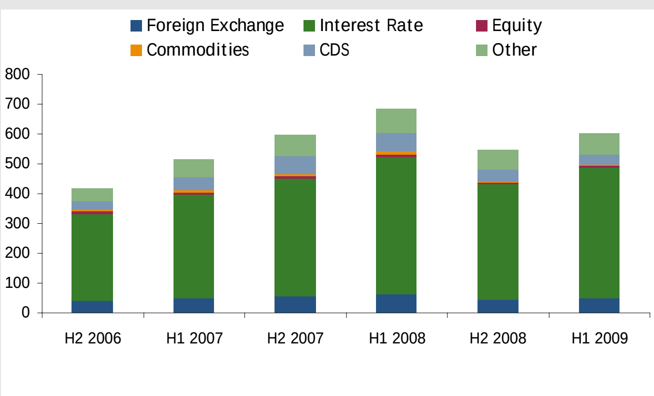
A Proposal for OTC Derivative Markets Reform

4 February 2010

Derivatives serve an important role in the financial system, supporting investment and economic growth. Derivatives enable companies to efficiently access additional funding sources and achieve lower financing costs, and enable investors to create and hedge portfolio exposures. In addition, derivatives such as CDS are important for ensuring that credit markets remain transparent and efficient. Understanding the concern that has arisen from the recent financial turmoil and the corrections that are required, we worry that some have mistakenly portrayed derivatives, especially credit default swaps (CDS), as the cause of the crisis. Credit default swaps offer advantages over their cash counterparts, with greater liquidity, flexibility, and opportunities for portfolio diversification and protection. Figure 1, illustrates the expanded role of the Global OTC Derivatives market. Portfolio managers now consider these instruments as an essential tool for managing portfolios as they provide the liquidity and flexibility needed to manage portfolio risk parameters in the current market environment.

We support legislative and regulatory initiatives that will help to reduce risk in our global financial system and improve protection for all market participants. Our clients benefit from deep and liquid markets, and it is important to consider the impact of any changes so as to continue to foster fully functional markets in all asset classes.

Figure 1: Global OTC Derivatives: Notional Amounts Outstanding (By data type & market risk, USD in trillions)



Source: Bank for International Settlements

In crafting new regulatory oversight, it is important to balance systemic and other risk concerns against new restrictions on these important financial instruments.

Enhance OTC record keeping and reporting requirements

Robust record keeping and reporting requirements in OTC derivatives trades will enable regulators to view and understand counterparty exposures and the interconnections between OTC markets, exchange traded markets and cash/physical markets. This should provide industry supervisors with the information necessary to manage systemic risk concerns. It is essential, however, that trade information be considered highly confidential information to ensure the strategies of specific investors are not communicated to the market (which could increase volatility in the markets and increase the costs of implementing hedging and other strategies). We do support the release of aggregate trade data within a timeframe that the relevant regulator determines to be appropriate.

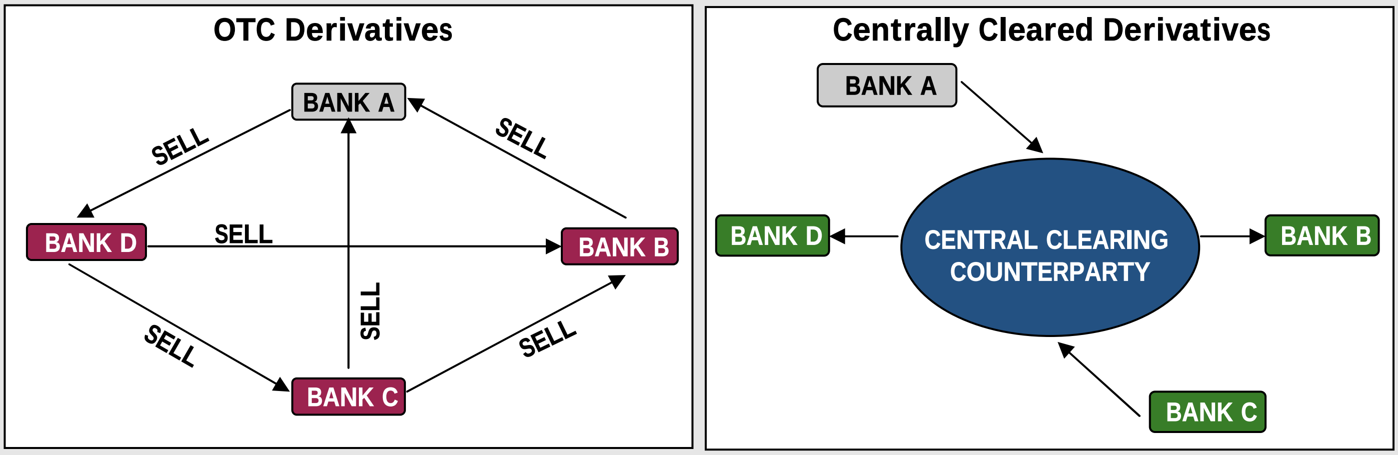
Require clearing of eligible OTC derivatives through regulated central counterparties/ clearinghouses

The trend in the market is toward more centralized clearing of OTC derivatives. Figure 2 illustrates the role of a clearinghouse in reducing counterparty risk through the offsetting of equal and opposite positions of market participants. This development is beneficial but it should be noted that the creation of central clearing counterparties or clearinghouses does not remove counterparty risk but instead concentrates it in new institutions which could be seen to be ‘too big to fail’. Default funds for these clearinghouses must be extremely robust, including legal certainty for the protection of customer assets. Without such protections another financial crisis could require government intervention to prevent the failure of a clearinghouse.

Not all OTC derivatives can or should be cleared and as discussed below, there are ways to protect against systemic risk while still allowing flexibility for customized solutions. In structuring any central counterparty or clearinghouse, a critical feature is that the needs of both buy-side institutions and dealers are met.

The opinions expressed are as of February 2010 and may change as subsequent conditions vary.

Figure 2: Clearinghouse as a Central Counterparty



If Bank A defaults, all other banks are at risk from the knock on effect – not just Bank D

If Bank A defaults, all other banks are protected by the Central Clearing Counterparty

Collateral and Segregation: Contracts that are cleared should be sufficiently collateralized to protect the exposed counterparty. In the event of a clearing member's default, initial margin that has been posted needs to be segregated from the proprietary assets of the counterparty and must be freely transferable by that counterparty. Similarly in the event of a default by other clients of a clearing member, any omnibus account at the clearing house must be structured in such a way as to limit, if not remove, the impact on the non-defaulting client's posted collateral.

Position portability: In the event of a clearing member's default client positions must be portable and freely transferable. To achieve this, contract terms and the rules of the clearinghouse need to be such that positions held with one counterparty are interchangeable with those of another.

Fungibility: The goal should be to maximize contract standardization to allow for netting and compression of positions across multiple clearinghouses. This will allow an increase in liquidity and competition between platforms while reducing the unnecessary impact of large collateral requirements on firms utilizing multiple clearinghouses.

Investment of cash collateral: In order to assure that collateral/initial margins are invested conservatively, there should be investment limitations on these monies. The regulatory agency with oversight over the clearinghouse and its participants should be required to establish standards for the investment of collateral for both clearinghouses and clearing members. In addition to assuring that the collateral is invested so as to minimize the risk of investment loss, these standards should also restrict the use of bank deposits (where the depositor risks becoming a general creditor of the bank if it should fail) and instead require the use of money market mutual funds or equivalently structured vehicles that are legally separate from the sponsoring institution. A similar approach is used today by the CFTC in setting segregation rules for futures initial margin.

Valuation transparency: Valuation calculations done by clearing organizations should be clearly understood so that both clearing members and their clients can verify and replicate valuations. Within clearinghouses the method of calculating and setting margin payments should be public, open to debate and verifiable by all participants.

Timing: OTC derivative trades subject to a clearing requirement, whether dealer to dealer or between a dealer and end-user, should be submitted to a clearinghouse on the same day as the trade. The end goal should be to achieve novation at point of trade.

Exemptions and Exclusions: To achieve the full benefits of market risk reduction, exemptions from a clearing requirement based on the status or activities of the counterparty, such as certain end-users, should be drafted narrowly. Non-financial companies utilize derivatives to mitigate risks arising routinely in their business such as in currencies, interest rates and commodities. Exemption rules should be written so as to distinguish between commercial business end-users and speculative or financial end-users. In certain cases, companies will engage in both types of activities and exemption language should allow for the distinction to be made by industry supervisors. Any end-user based exemption should also be written to prevent counterparties from structuring their activities for the primary purpose of avoiding a clearing requirement.

FX Forwards and Swaps: Forcing FX to be cleared would introduce new systemic risk into the system and impose large costs on companies that trade internationally. Used for a variety of international transactions, the $3,200 billion-a-day market trades around the clock and assists cross-border trade and investment by allowing businesses to convert from one currency to another. The inclusion of FX forwards and swaps in central clearing should only take place once the rates and credits changes have been successfully integrated into the market.

No Mandatory Exchange Trading of All Derivatives

While we support initiatives to increase the clearing for OTC derivatives, and value the price discovery function provided by exchange trading, we do not believe that it is necessary or desirable to force all OTC derivative transactions onto an exchange. Exchanges tend to work best for highly liquid and standardized contracts. We recognize that customization is sometimes necessary to meet particular hedging or investment needs. Bilateral OTC contracts should be permissible, subject to appropriate collateralization requirements and the recordkeeping and reporting requirement.

Conclusion

We support efforts to improve the regulation and oversight of OTC derivative markets. As a fiduciary for clients and a major participant in the both exchange traded and OTC derivatives markets, we want to ensure that new restrictions on these important financial instruments address the existing risk concerns but do not create unintended negative consequences. By maintaining the focus of reform on risk mitigation, legislation can be enacted that will address risk in the market but continue the ability of these products to meet the needs of investors.