Regulatory Reform of the Over-the-Counter Derivatives Markets: A Solution for the AIG Catastrophe?

Prof. Nancy Wallace
University of California, Berkeley
Haas School of Business
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**Amplification of the Crisis: Credit Default Swaps**

1) Buyer of credit protection pays periodic fee.
2) If the reference credit defaults, protection-buyer delivers reference credit to protection-seller, in return for a payment of principal amount on the bond.
   - AIG – protection seller of CDS on residential mortgage backed securities (required Federal bailout of $180 Billion).
   - Goldman Sachs – protection buyer of CDS on residential mortgage backed securities (recipient of $13 Billion in margin payments on AIG CDS through bailout agreement)

Protection Buyer ➞ Premia ➞ Protection Seller
Cash settle default events at Par.
Credit Default Swaps: Significant Counterparty Risk

$Trillions

Source: Authors calculations, New York Times, Federal Reserve Flow of Funds, L.4 Credit Market Debt, International Swaps and Derivatives Association
CDS Counterparty Risk

◆ Completely unregulated, privately negotiated bilateral over-the-counter trading structure.
  » No regulator, no standardized capital requirements, no standardized valuation methods, no standardized contract structure.

◆ No central clearinghouse or system for recording trades.
  » Still do not know where it all is!!

◆ CDS positions are long and can only be “unwound” with countervailing positions.
  » Many different counterparties, many different maturity structures, many different ratings.

◆ Bears Stearns, AIG, Lehman all important “sellers” of CDS – fee businesses with inadequate capital!
Possible Investment Banking
Regulatory Responses

- Establish a clearing house for credit default swaps
  - Make them exchange traded and the exchange becomes the counterparty for both sides of the trades.
  - Allow the dealers to clear net amounts of their CDS obligations at the end of each business day – like check-clearing mechanism in major financial centers.
  - COST: standardization, but BENEFIT: transparency.
## Current Outstanding CDS

<table>
<thead>
<tr>
<th>CDS by Counterparty</th>
<th>($) Billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dealer to Dealer</td>
<td>$3,177</td>
</tr>
<tr>
<td>Dealer to Other Financial Institution</td>
<td>$2,377</td>
</tr>
<tr>
<td>Dealer to non-Financial Customer</td>
<td>$98</td>
</tr>
<tr>
<td>Total</td>
<td>$5,652</td>
</tr>
</tbody>
</table>

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**Market concentration remains important:** J.P Morgan is largest OTC derivatives dealer by volume, with a total notional position of $87 trillion.
Administration Proposal for Reform of the OTC Derivatives Markets

◆ **Mechanisms to Lower Risk**
  - Dealer capital requirements.
  - Margin requirements to mitigate counterparty risk.
  - Robust business conduct standards – timely and accurate confirmation.
  - Standardized OTC transactions cleared by central counterparties.

◆ **Mechanisms to Increase Transparency**
  - Record keeping and reporting requirements.
  - Non-cleared transactions revealed to regulators.
  - Aggregated data made available to public
  - Standardized OTC products moved to exchanges, or regulated trade execution facilities.
OTC Derivative Markets Act of 2009

◆ Mechanisms to Lower Risk – Major changes
  
  – Robust business conduct standards – rules limited to major security-based swap participants does not include brokers to retail investors.
  
  – Shifts clearing from all standardized derivative products to product criteria to be determined by regulators
    » Exempts all end-users with “risk management” purposes.
  
  – Exempts customized swap securities.

◆ Mechanisms to Increase Transparency – Major changes.
  
  – Standardized cleared OTC derivatives not required to trade on exchanges, or regulated trade execution facilities.
Many Troubling Details Lacking

◆ What is a standardized OTC derivative – more liquid, easier to value?
◆ How many clearinghouses? Monopolistic or competitive structure? Product specialist?
◆ Are the capital requirements for the clearinghouses sufficient (stress test standards)?
◆ What is the cost of the clearinghouse for differing products?
◆ How is systemic risk to be measured and does clearing reduce these risks?
◆ Will narrowly drawn definitions lead to unintended regulatory arbitrage (distinctions between indexed and named products or “customized” and “standardized” swaps)?