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

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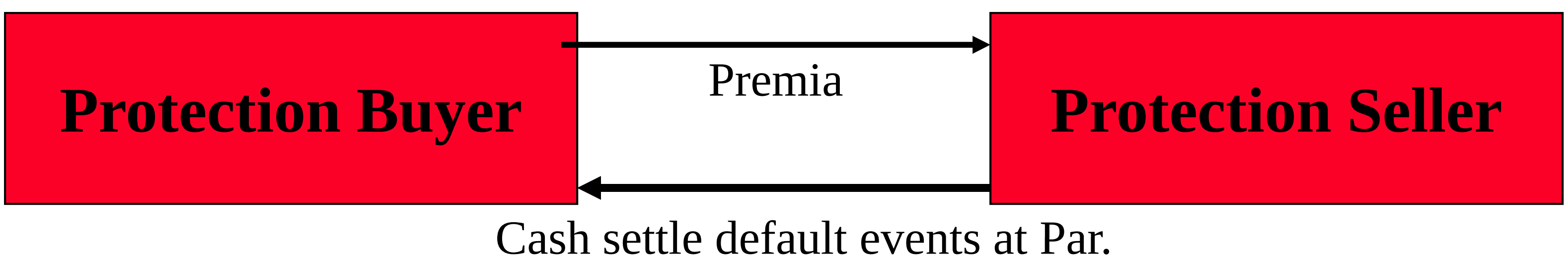
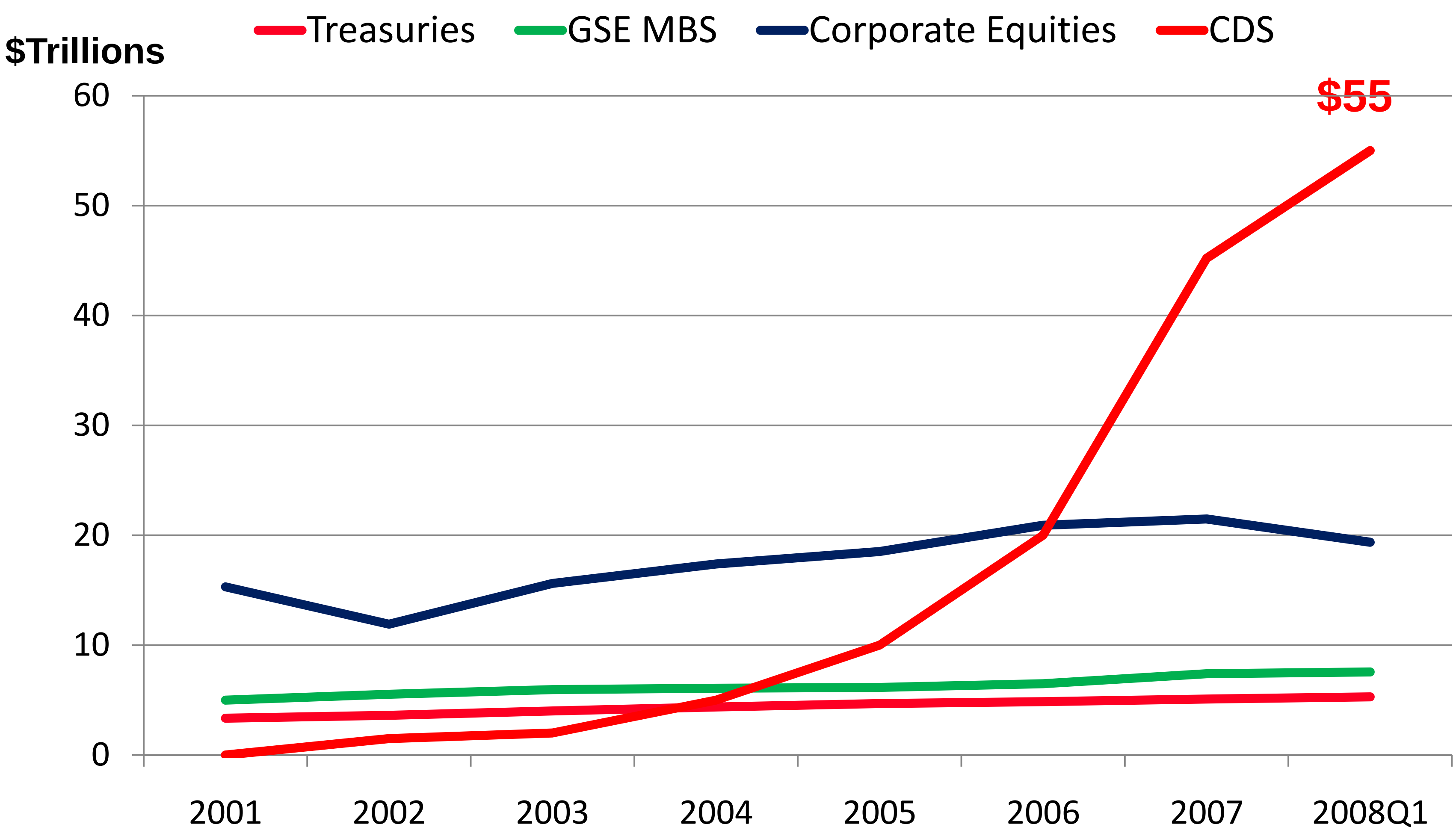
Amplification of the Crisis: Credit Default Swaps

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)



Credit Default Swaps: Significant Counterparty Risk



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 bi-lateral 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

CDS by Counterparty ($ Billions)	
Dealer to Dealer	**$3,177**
Dealer to Other Financial Institution	**$2,377**
Dealer to non-Financial Customer	**$98**
Total	**$5,652**

BIS, May 2009

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)?