Risk Management In Derivatives CCPs

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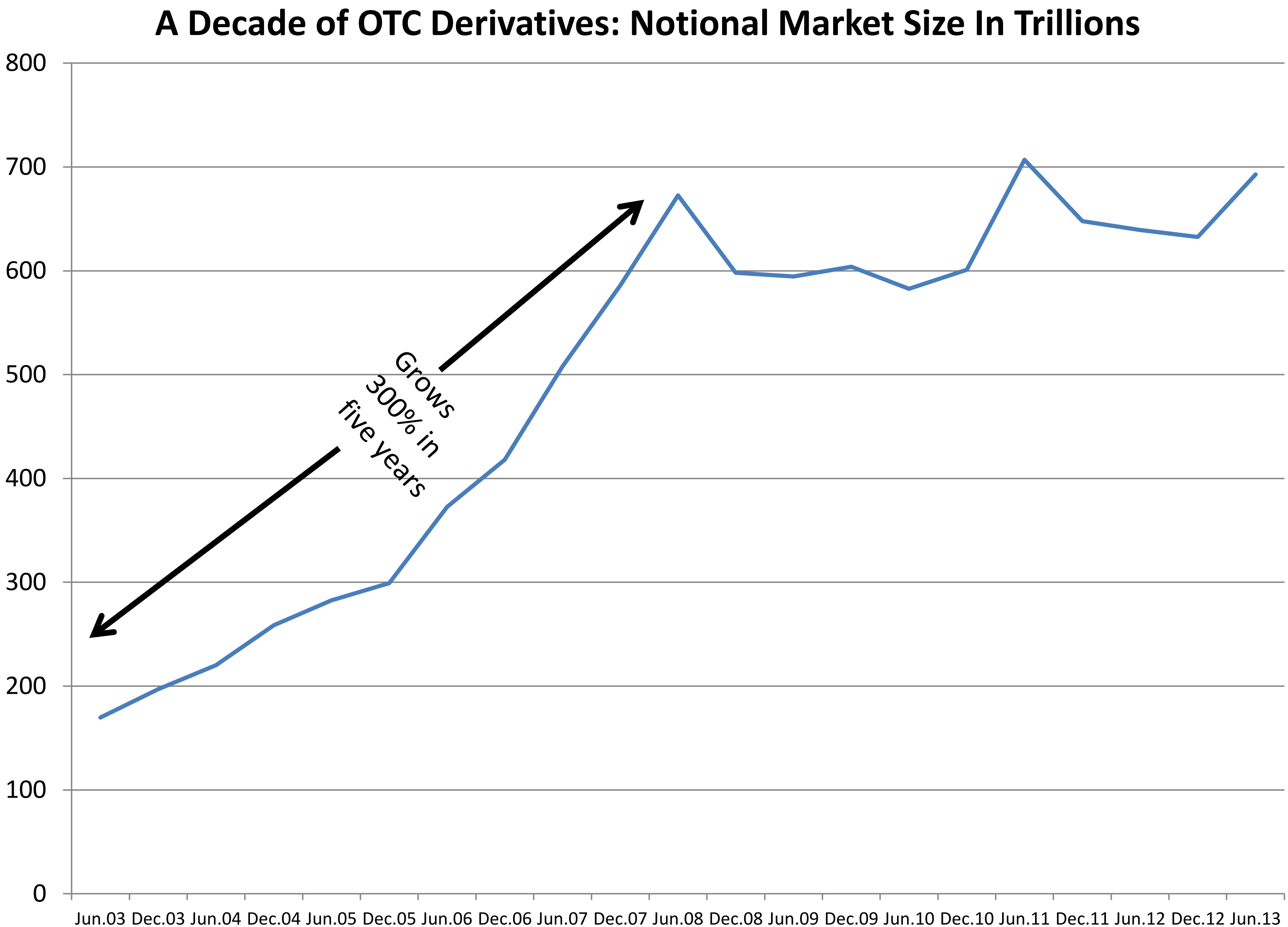
(Views expressed are my own)

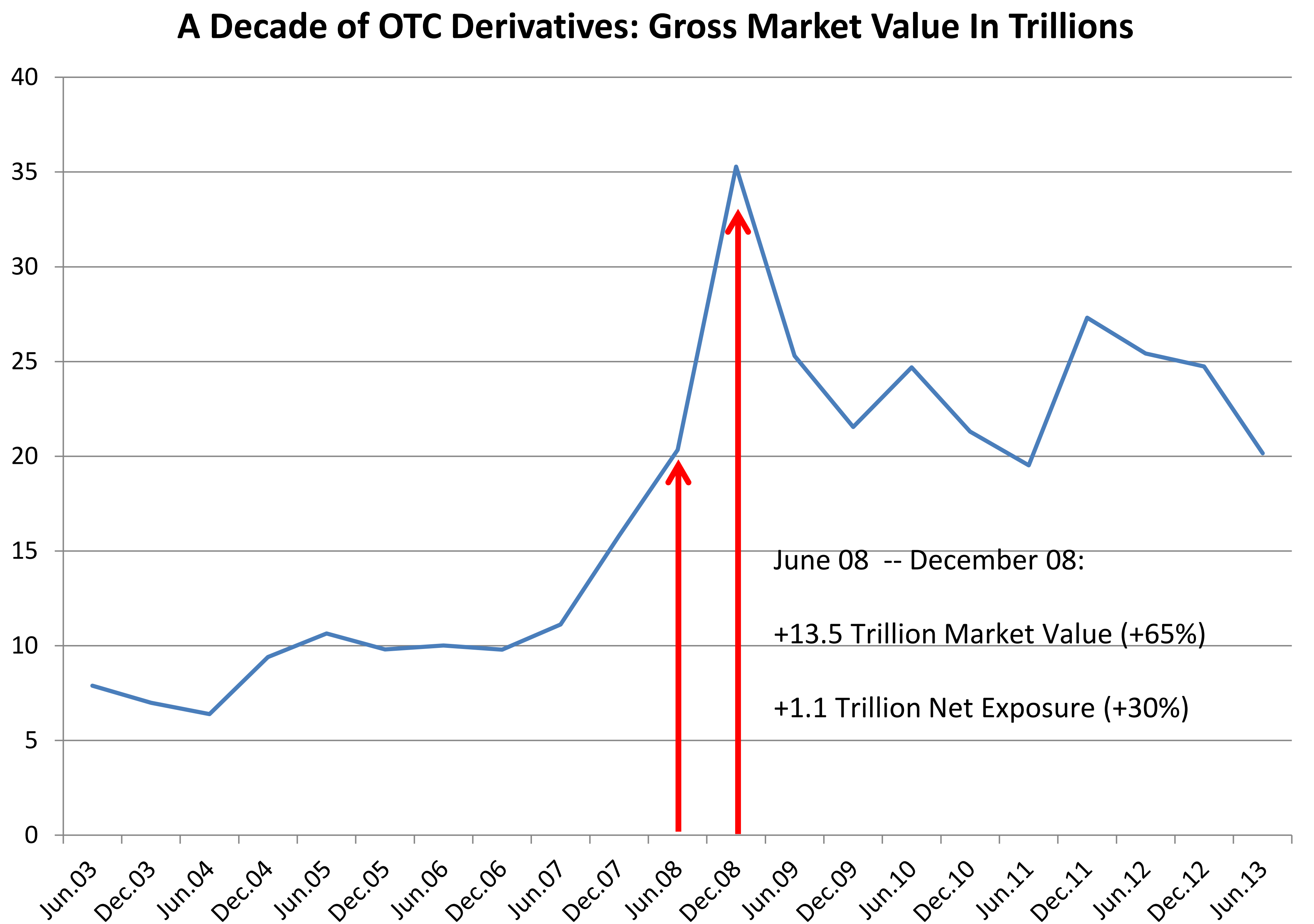
Americans for Financial Reform

- Public interest coalition: 250 member groups.

- Goal: a public interest voice in the regulatory and legislative process.

- There is great public concern about these issues. Vital to leverage non-partisan technical analysis to properly direct that concern.


A Decade of OTC Derivatives: Notional Market Size In Trillions
800
700
600
500
400
300
200
100
0
Grows 300% in five years
Jun.03 Dec.03 Jun.04 Dec.04 Jun.05 Dec.05 Jun.06 Dec.06 Jun.07 Dec.07 Jun.08 Dec.08 Jun.09 Dec.09 Jun.10 Dec.10 Jun.11 Dec.11 Jun.12 Dec.12 Jun.13


A Decade of OTC Derivatives: Gross Market Value In Trillions
40
35
30
25
20
15
10
5
0
Jun.03
Dec.03
Jun.04
Dec.04
Jun.05
Dec.05
Jun.06
Dec.06
Jun.07
Dec.07
Jun.08
Dec.08
Jun.09
Dec.09
Jun.10
Dec.10
Jun.11
Dec.11
Jun.12
Dec.12
Jun.13
June 08 -- December 08:
+13.5 Trillion Market Value (+65%)
+1.1 Trillion Net Exposure (+30%)

Size and Volatility: Implications

- Systemically significant liquidity and capital demands in stressed periods.

- Provisioning: either demanding in normal times or highly pro-cyclical.

- Significant closeout and resolution risk.

Clearinghouses

- Do not in themselves change these basic risks and tradeoffs of the derivatives market.
- But can offer a superior workshop for managing them.
- Heavy political investment in clearing: the public expects this management to succeed.

Basic Points

1. Clear and forceful regulation required to realize the potential advantages of clearing.
2. But large tail risks will remain.
3. Regulators must be willing to increase derivatives cost to reflect tail risks.
4. Attention is required to full waterfall and resolution.
5. CCP regulation must be integrated with bank regulation – clearing members are banks.
6. Must avoid implicit reliance on the public backstop.

Realizing Clearing Advantages: <u>Advantages of Clearing</u>

1. Specialized for risk management.
   – limited scope of activities reduces moral hazard.
2. Greater transparency.
   – counterparty exposures, standardized instruments, collateral management.
3. More opportunities for netting and compression.
4. Mutualized incentives in default resolution.
5. These advantages should flow <u>naturally</u>.

Realizing Clearing Advantages: <u>Key Areas For Regulatory Attention</u>

- ‘Race to the bottom’ and pro-cyclical incentives on portfolio margining (correlation assumptions) and collateral management.
- Standardization of derivatives for clearing.
- Press multilateral netting and compression advantages: depend on market structure.
  - Conflict between market power concerns and efficiency in risk management?

IMF Simulation

	ACTUAL	ASSUMPTION 1	ASSUMPTION 2
Market Condition		Normal	Volatile
Assumed Portfolio Hedging		High (99%+)	Medium (84-93%)
Initial Margin	$17 B.	$17 B.	**$208 B.**
Default Fund	$4 B.	$9 B.	**$538 B.**

Actual and simulated Swapclear positions, close 2011. Dollars in billions.
SOURCE: Lin, Li and Surti, Jay, Capital Requirements for Over-the-Counter Derivatives Central Counterparties (January 2013). IMF Working Paper No. 13/3.

Attention Needed To Full Waterfall

1. Defaulter's variation margin.
2. Defaulter's initial margin.
3. Default's default fund contribution.
4. Clearinghouse equity.
5. Non-defaulters default fund contribution.
6. Clearing member capital calls.
7. Resolution procedure.

Integrating Bank and CCP Regulation

- Capitalizing bank exposures to CCPs
  - ‘Incentivizing’ clearing through lowering capital charges on cleared derivatives?
  - Banks are not ‘offloading’ risks.
- Liquidity requirements for CCP margin.
- Collateral transformation.
  - Removes credit exposure from a CCP only to recreate it elsewhere in the system, where it must be managed.

Avoid Reliance on Public Backstop

- Title II resolution is not appropriate for clearinghouses: CCPs are a ‘ball of liquidity’.
  - Little debt or equity to draw on.
  - Total circularity between liquidity line and entity valuation that secures lending.
- Significant controversy around access to Fed discount window for clearinghouses.
  - Sheila Bair; Brown-Vitter.

So Where Do We Stand?

- Clearly regulatory attention to some of these issues – notably margin and default fund.
- But the devil is in the details.
  - Less detailed regulation on modeling in these areas than for bilateral bank-held derivatives.
- Less apparent attention to tail risk implications for managing the lower levels of waterfall.