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Amending Safe Harbors to Reduce Systemic Risk in OTC Derivatives Markets

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Motivation

- How will regulators under Dodd-Frank decide what is to be reported and cleared and what these requirements mean?
 - If coverage is too narrow and requirements too weak:
 - Systemic risk not reduced as desired
 - If coverage is too broad and requirements too onerous:
 - Systemic risk created through clearing organizations
 - Efficient economic transactions shut down
 - Risk and leverage driven somewhere else
- ***Narrow the derivatives safe harbor to include only trades that are cleared in the sense of 3rd-party pricing and collateral management.***

Fears for Market Robustness

- Inadequate MIS
 - “Many large banks simply do not have the systems to present an up-to-date picture of firm-wide links to ... trading partners. Two-thirds ... said they were only ‘partially’ able (in other words, unable) to aggregate their credit risks. The Fed ... was shocked to find that some ... needed days to calculate ... exposure to derivatives counterparties.”
- Complexity
 - Notional size
 - Multiple entities / intra-company trades
- Safe harbor liquidations might be destabilizing in a crisis
 - Liquid markets (e.g., IRS, corporate CDS) were not disrupted.
 - Illiquid markets froze, risking disruption (e.g., AIG’s CDS).

Safe Harbor for Derivatives

- Pros:
 - Enables leveraged institutions to hedge risk through a crisis.
 - Bankruptcy stay for fungible assets, like most derivatives, is not important to an estate .
- Cons:
 - Safe harbor liquidations in a crisis could destabilize markets and result in a cascade of failures.
 - Giving priority over other creditors results in bigger, more concentrated, and more illiquid positions than would otherwise be chosen.

Clearing

Level of “Clearing”	Description
I	3 rd -party pricing and collateral management
II	Level I + CCP (Central or Clearing Counterparty)
III	Level II with a limited number of standard contracts

- Level I clearing provides
 - complete and accurate reporting (could include intra-company trades)
 - pricing, risk, and margin transparency
 - facilitates compression
 - easy relative to Level II

CCPs May not Reduce Systemic Risk

“Clearinghouses Are the Answer,” Gary Gensler, WSJ, April 21, 2010

- Mutualization not elimination of risk
- CCP may not manage risk better than bilateral counterparties, particularly for less liquid products.
- CCP itself is a source of systemic risk.
- May lose cross-product risk reduction.
- The track record of CCPs is extremely good but
 - there have been near disasters;
 - there is no track record for less liquid products.

	Do we want a derivatives safe harbor as a matter of policy?	Will markets clear derivatives if the safe harbor depends on it?
“Liquid” Derivatives	<p>Yes:</p> <ul style="list-style-type: none"> • Let leveraged firms hedge through a crisis. • Liquidations pose little systemic risk. • Assets are not firm-specific. 	<p>Yes:</p> <ul style="list-style-type: none"> • Pricing and risk are simple enough to be delegated. • Safe harbor protection will be worth the costs to counterparties.
“Illiquid” Derivatives	<p>No:</p> <ul style="list-style-type: none"> • Entities cannot hedge anyway. • Liquidations pose systemic risk. • Assets may be firm-specific. • No intent to encourage financings in derivatives form. 	<p>No:</p> <ul style="list-style-type: none"> • Pricing and risk are not simple enough to be delegated. • Neither clearing entities nor counterparties will accept the risks of clearing.

Anticipated Policy Results

- Market participants will clear the appropriate (i.e., relatively liquid) derivatives at their own initiative, opting for CCPs as appropriate.
- Safe harbors will apply only where they reduce systemic risk.
- Market participants will be appropriately discouraged from trading illiquid derivatives.
- Regulators will have the position, price, and risk information they need to manage through a crisis.

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