

The Role for International Coordination in Reform of OTC Derivatives Markets

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Outline

- Focus for these comments: Clearing, Margins & Systemic Risk
- History of the debate so far
- The determinants of systemic risk
- Role for international coordination

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- Three key elements in reforming OTC derivative markets
 - 1. ALL trade in derivatives is regulated. No exceptions.
 - 2. Increased transparency.
 - ✓ Mandatory reporting of all transactions,
 - regardless of whether it is standardized or not, traded on an exchange or cleared.
 - ✓ Post-trade publication of trade data for most transactions, incl. bilateral deals.
 - ✓ Pre-trade publication of bids & offers through increased use of exchanges.
 - 3. Increased use of clearing.
 - ✓ Reduce systemic risk by lowering aggregate credit risk in the system.

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- Underlying assumption...
 - Systemic risk and aggregate exposures remain constant.

The determinants of systemic risk

- The key determinant of the total cost to end-users is the level of systemic risk and the aggregate amount of credit exposures in the system.
 - In a bilateral market, like the OTC swaps market before reform, credit exposures do not cancel out.
 - The purpose of clearing is to NET exposures, reducing the total amount of credit risk.
 - This sets the aggregate financing costs of end-users.
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- Will mandated clearing reduce total credit exposures?
 - Maybe. It depends on how it is implemented.
 - Fractured clearing can yield an increase in aggregate exposures.

Role for international coordination

- Task is to reduce aggregate credit exposures supporting a given volume of risk transferred through the financial markets.
- Global marketplace.
 - > Global market for products.
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 - > Cooperation is necessary in structuring the financial market.
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- Need to avoid fractured clearing. Need to find mechanisms for organizing the global market to reduce aggregate credit exposures.
- End-users have so far been focused on a false source of the costs of hedging, which is the form in which they pay-up for credit exposures. End-users should start focusing on the real source of the costs of hedging, which is aggregate credit exposures. This can be impacted by the structure of the global marketplace. End-users should become active participants in determining whether and how this global marketplace is structured to serve their business interests.

The End