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
Focus for these comments:
Clearing, Margins & Systemic Risk

- 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.
History of the debate so far

- End-users have not embraced reform
  - Concern that clearing and consequent margin requirements increase their cost of financing hedges and therefore the cost of doing business
  - In search of exemption

- End-user concern on margins is mistaken
  - There is no such thing as a free lunch, especially from your friendly neighborhood derivatives dealer.
  - Uncollateralized swaps contain an implicit credit line financing dealer’s exposure.
  - Dealers charge for the credit, so end-users are already paying.
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  - Uncollateralized swaps contain an implicit credit line financing dealer’s exposure.
  - Dealers charge for the credit, so end-users are already paying.
  - In a system with clearing and margins, the margin can be financed with an explicit credit line that costs the same. ...the same.

- 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.
    ✓ Keep your eyes on the prize!

- 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.
  - Global market for risk.
  - Cooperation is necessary in structuring the financial market.
- 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