ISDA Safe, Efficient Markets

Introductory Remarks
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I would like to start our conference program this morning with what we call "remarks." My remarks will revolve around an idea that could make our markets safer and more efficient.

The idea, at first, may seem like it is just another attempt by the industry to avoid regulation.

It is not.

Nor is it a formal proposal.

It is a simple way to achieve the goals regulators must have had in mind in making the G-20 commitments.

Our idea is actually far less expensive and potentially safer than what is being proposed.

The fact is, ISDA has supported many of the reforms put forth by global regulators as they try to remove risk from the financial system.

Unfortunately, some of these reforms are either very costly or may actually increase risk.

Let me note at the outset that we recognize the infrastructure for the reforms is underway and it may well be impossible to adopt alternatives.

Nonetheless, we do believe participants in markets should understand that alternatives are available.

We also believe that we can and should constantly strive to improve our markets.

Now that I have your attention, let me provide some background information that gives rise to our idea.

As the financial crisis unfolded, regulators might have characterized the OTC derivatives market and the risks they entailed in several ways.

First, there was a lack of knowledge about the build up of risks taken by market participants generally.

- What types of risks were participants taking and how much?
- Was everyone long or short, taking interest rate or commodity risk?

- What about all the structured finance and the newest product, sub prime mortgage repackaging?
- Had that invaded the derivatives market?

Second, there was lack of knowledge about which entities were taking these risks.

Hedge funds, monolines, SIVs and other structured vehicles were using products and employing leverage outside the scope of regulators.

Were they using derivatives to take these risks?

Third, the market was comprised of hundreds of trillions of dollars of notional amounts with thousands of participants.

The vast majority of these positions were documented with the ISDA Master Agreement.

Most corporations, many insurance companies and nearly all governments did not post collateral.

It was believed that most hedge funds posted both mark to market collateral as well as a form of initial margin.

Regulators were quite sure that dealers posted only mark to market collateral.

The good news was that dealers had recently been utilizing clearinghouses for interest rate swaps, and they were developing plans for clearing credit default swaps.

Many users of derivatives were required to post collateral but only once exposures exceeded certain thresholds specified in the contracts.

Others only had to post collateral if credit ratings fell.

Fourth, the diversity of collateral arrangements provided little confidence among regulators that they could predict the outcomes of a dealer default.

- Were major financial firms so interconnected that a failure of one could lead to a string of others?
- How bad would the effects of a dealer default be on its customers and the general economy?

Finally, regulators had worked hard, they probably believed too hard, to get the industry to strengthen its trading infrastructure: systems that would electronically confirm trades; procedures to reconcile portfolios and pricing; and the elimination of manual intervention.

It was in this context that global finance minsters met in Pittsburgh in 2009.

They pledged to have standardized trades cleared and executed on electronic platforms or exchanges.

They also required that all trades be reported to newly formed trade repositories.

Clearing was intended to reduce counterparty and systemic risk although it was noted that the nastiest derivative contracts – such as those involving structured mortgage products - might never be cleared.

Clearing also assured that defaults would be managed efficiently and in a pre-ordained method.

Trade repositories were expected to give regulators insights into concentrations of risk in the marketplace.

We at ISDA have been very much involved with reform throughout the world.

Much of this reform looks to be very beneficial.

But, as noted, elements of the reform might either increase risk or be very costly.

We regret that there has been little cost benefit analysis in designing the reforms. In fact we hope to publish a report in the next few weeks examining the costs and benefits of mandatory execution on SEFs.

We think such analyses might have pushed reform in other directions.

But let's look at the G-20 commitments.

Trade repositories generally look like a very good thing, although the objective of reporting has evolved beyond safety.

Now, trade repositories are meant to capture and report trade data in real time and provide pricing for the market.

This, of course, costs money and delays the delivery of the original product.

Trade repositories have encountered confidentiality issues and may not be the ideal method of obtaining information regarding counterparty credit exposure.

For this and reasons relating to netting, ISDA has recommended that dealers provide counterparty exposure in a standard format to appropriate regulators, either directly or through a counterparty information repository.

But in all, ISDA supports the trade repository effort.

The clearing objectives, managing counterparty credit risk, systemic risk and the dealer default process are excellent objectives.

Unfortunately, they have created some issues that reduce the benefits they were meant to produce.

The first is the proliferation of clearinghouses.

It appears now that we may have multiple clearinghouses for individual asset classes and such clearinghouses will be established in many countries.

The result will be risk exposures to dozens of clearinghouses and a reduction of the efficiency of the clearinghouses generally.

We will also see a fragmentation of the netting benefits that currently exist through bilateral relationships.

Firms will be required to clear some trades that are hedges of positions that cannot be cleared.

Splitting up these trades means exposure that was netted off is no longer netted.

Again, exposure in the clearinghouse is created and exposure that was hedged is now unhedged.

The clearing mandate also raises important issues regarding the amount of capital that would be tied up.

Various studies and estimates have shown that initial margin for entities now forced to clear may run from $200 billion to as high as $500 billion or more.

The “cost” of this liquidity is difficult to define but we suggest, at the low end, that it could be $1 billion or 0.5% times the $200 billion of initial margin.

At the high end, initial margin could be $5 billion, or 1% times $500 billion. That is, of course, a per annum cost.

We have seen no studies that estimate the amount of money that might be saved by such a large amount of IM.

In the US banking system, ISDA has produced a study that shows about $2 billion of counterparty credit losses were realized from 2007 to 2010 on exposures to all counterparties (this excludes Lehman).

We believe a large majority of these losses were due to defaults of corporations or of financial firms on highly structured products that already had IM or has neither variation margin or IM.

The imposition of IM on the entire set of financial firms utilizing derivatives would have had very little effect on losses.

So this brings me to the idea I noted upfront.

I will repeat: it is not a formal proposal. But it should spur further analysis.

Our idea is as follows:

First, dealers should be required to clear trades with one another.

Initial margin posting for very active participants can be very efficient.

However, we believe interdealer trades that are eligible for clearing may remain out of clearing to the extent and only to the extent they hedge the market or credit risk of trades not eligible for clearing.

Second, no other counterparties should be forced to clear.

I hope that gets your attention.

All financial firms, other than small firms, should, however, be forced to post variation margin. (Financial firms may exclude sovereigns and supranationals.)

Such margin should be bilateral, should contain no thresholds and should be posted daily.
This is very important.

Regulators will know the exposures are collateralized.

Initial margin may be privately negotiated and segregated depending upon the credit of each party, the type of product, and the extent of the portfolio of derivatives between the counterparties.

The absence of initial margin may cost dealers and their clients from time to time but nowhere near $1 billion to $5 billion each year.

How do we make sure this collateralized system works and that defaults can be managed expeditiously?

It seems relatively simple to establish a service that can record and value all trades between dealers and financial firms.

The service could also ensure collateral is passed between the parties in accordance with portfolio requirements.

Collateral would encompass all transactions that would be subject to netting.

Reports could be sent to regulators that would be organized by counterparty.

The reports would be complete and relatively simple.

The biggest issue will be valuation of complex trades.

Where possible the service would develop pricing models. If this is not possible for certain transactions, the service could use dealer pricing – just as the market currently works.

How about default management?

Here again, a service could be developed relatively easily.

The service could unwind trades in the event of a dealer default if agreed to by the financial firms that suffered the default of a dealer.

Agreement would be required as payments will often be needed to close out positions.

The service might be undertaken by a large financial institution that would be willing to take the modest payment risk for the system for a reasonable fee.

Remember, the system would be saving billions per year.

We know it's late in the game to suggest this idea.

But it arose only out of appreciation of the costs of the market infrastructure that is being implemented.

Those costs were not known before but are becoming more and more apparent as the rulemaking process progresses.

Look what the idea achieves: Full variation margin, doing away with dozens of clearinghouses, retaining the benefits of netting, saving $200 billion to $500 billion of IM and better disclosure.

In short, we are convinced there is a better way.

We urge market participants to develop these and other proposals that respond to policy concerns.

And we ask regulators to have open minds when the ideas become concrete proposals.

We, for one, are working on an interesting variation of this idea.

Our proposals may come in 2012, 2013 or several years later.

We are convinced there are more ways to make the markets safer and more efficient, both from where we are today and where regulation is taking us.

That is really the idea I would like to leave you with today.