

REGULATION IN THE AFTERMATH OF THE FINANCIAL CRISIS

- CENTRAL COUNTERPARTY CLEARING OF CREDIT DEFAULT SWAPS

AND OTHER OVER-THE-COUNTER DERIVATIVES

Introduction

The financial crisis has resulted in a vivid debate regarding the use of several financial innovations introduced in the last decade. Among those instruments most questioned is the credit default swap (“CDS”), which is considered to have been one of the most aggravating factors in the financial crisis. The CDS is perceived as having been a key factor behind the failure of American International Group (“AIG”). As a result, the regulatory framework governing a CDS as well as other types of over-the-counter (“OTC”) derivatives (that is, privately negotiated derivative contracts) is likely to be strengthened. For example, the European Commission (“EC”) has expressed a view that a regulatory review will be conducted during the course of this year.. This is likely to include a requirement to use central counterparty clearing, which will impact on the way in which Swedish financial institutions and other companies currently conduct their OTC dealings.

A downside to the expected rules is that they will make hedging more expensive. Central counterparty clearing will, for example, result in an increased demand for collateral and potentially a drain of cash among the users of OTC derivatives. As a result, users of OTC derivatives are currently lobbying to try to limit the scope of any future regulation.

This article aims to highlight the main aspects of the ongoing debate. It firstly describes the background to the current regulatory initiatives. It then elaborates on the requirement to use central counterparty clearing. Particular, focus will be on the issue of how to balance the interest of the users (to hedge risks cheaply and efficiently) and the interest of the policymakers (to strengthen financial stability).

Background – credit default swaps and the financial crisis

Derivatives are financial instruments used to mitigate (or speculate in) various risks, for example interest rate and exchange rate risks. Derivatives as such have existed for long time; the

Chicago Board of Exchange, for example, introduced derivatives related to the price of grain back in 1865. However, during the last decade the use of derivatives related to credit risk (collectively referred to as credit derivatives) has increased rapidly. The most common type of credit derivative is the CDS. It is in relation to these instruments, and the role they played in the financial crisis, that the ongoing discussion on greater regulation of OTC derivatives has emerged.

A CDS is a financial instrument used to transfer default risk related to a specific exposure, for example, a company or a government ("reference entity"). The party seeking to hedge against (or speculate in) the default risk ("protection buyer") pays a periodic fee to the party offering the protection ("protection seller") during the term of the CDS. If the reference entity fails to pay its debt or some other "credit event" (for example bankruptcy or restructuring) occurs, the protection seller is obligated to compensate the protection buyer for the loss. Thus, a CDS can be described as a form of credit insurance, even though - from a regulatory perspective - the instruments are not considered to be insurance contracts.

One of the driving forces behind the development of the CDS has been the demand by banks and other financial institutions to be able to hedge and diversify credit risk as they would other risks. This demand has been prompted not merely by the nature of their business, but also by regulatory incentives, mainly the global capital adequacy regimes developed by the Basel committee, which have been implemented in several jurisdictions throughout the world (in Europe through the so-called Capital Requirements Directive). Furthermore, these factors have been combined with a demand for low-cost credit exposure and a general view that the instruments, by spreading risk, contribute to a more resilient financial system. As a result, the development of CDSs has also been embraced by regulators and supervising authorities. As a result of these characteristics, the CDS market has grown rapidly; in June 2007 the aggregated value of the CDS market was approximately USD 40 trillion.

However, the financial crisis has illustrated that in some circumstances, CDSs can contribute to the build-up of systemic risks. The instruments have, therefore, been heavily criticized. The well-known American investor Warren Buffet has referred to them as "weapons of mass destruction". Arguably, CDSs aggravated the financial crisis in several ways (for example, by enabling banks to lay-off credit risk, thus contributing to the general credit accumulation) but the main aspect highlighted in the criticism of the instruments is the role they played in the failure of AIG.

AIG had acted as protection seller on a large number of CDSs related to the US subprime mortgage market. This had typically been done by offering credit protection (in the form of CDSs) on the senior tranches of various structured products (such as collateral debt obligations) secured on such assets. When the US housing market declined, which particularly affected the subprime market, AIG had to be "bailed-out" by the US government. The rationale behind the rescue, from the US government's perspective, was that AIG was "too-interconnected-to-fail"; the company had a key role in, for example, several OTC markets and a failure of AIG was considered to pose a risk to the overall system stability (especially with the consequences of the fall of Lehman Brothers in mind).

The story of AIG has raised the question of counterparty risk on the OTC derivatives markets. That is, not only in relation to “exotic” derivatives such as CDSs but also “plain vanilla” products such as interest rate swaps and exchange rate swaps (even though these markets and instruments did not contribute to the crisis in any significant way). After all, the inherent weaknesses of the CDS market (for example the issue of counterparty risk) also largely apply to other OTC derivatives. Therefore, the pending regulatory reform is likely to affect Swedish financial institutions and other companies even though their use of “exotic” derivatives such as CDSs is very limited (the main part of the USD 40 trillion CDS market is located in financial centres such as London and New York).

Central counterparty clearing of OTC derivatives

As a response to the problem of counterparty risk, it has been proposed to introduce a requirement to use central counterparty clearing in relation to OTC derivatives. In essence, a central counterparty (“CCP”) “guarantees” – by entering into the relevant transaction between the original parties – the due fulfillment of respective party’s obligations. In other words, the original agreement between the parties is replaced by two mirroring agreements: one between the seller and the CCP and one between the buyer and the CCP. Therefore, as long as the CCP is sufficiently well-capitalised, the risk of “contagion” and daisy-chains of failures is mitigated. In addition, the use of a CCP increases the possibilities of netting and set-off (by creating sufficient mutuality even in cases where the claims are between different parties) and a CCP can also contribute to increased market transparency by collecting information on all transactions to which it is a party and reporting the statistics to, for example, the supervising authorities. From a financial stability perspective it is not, therefore, surprising that regulators and policymakers have adopted the idea of central counterparty clearing as a response to the recent market turmoil.

From a user-perspective the requirement to use CCPs is, however, likely to result in increased costs for hedging. That is because a CCP typically demands collateral in relation to each transaction to which it is a party, thereby restraining the users’ liquidity. Therefore, the scope of the requirement needs to be carefully considered. Among the issues currently being discussed in relation to the forthcoming EC proposal are (i) what type of *contracts* should be subject to the requirements, and (ii) what type of *users* should be subject to the requirements. These issues are further touched upon below.

The general view is that only “standardised” instruments are suitable for central counterparty clearing. Among other things, standardisation is considered to be a pre-requisite for efficient risk control within the CCP; a standardised (and thus liquid) market is necessary in order for a CCP to be able to transfer contracts in the event of default of one of the original parties. Therefore, a requirement to clear all OTC derivatives would, in practice, result in several instruments being “prohibited” and the general view seems, therefore, to be that the requirement to use a CCP should relate only to such instruments considered to be *standardised* whereas *non-standardised* instruments would continue to be cleared bilaterally. According to proposals from European policymakers (and similar proposals have been put forward in other countries and regions as well) the risk of non-standardised OTC derivatives would instead be dealt with through a review of the capital adequacy requirements relating to such instruments.

A further issue concerns the type of *users* that should be subject to the requirement. Obviously, the simplest solution is to include all users. However, from a financial stability perspective, not all users are equally important; a global financial institution (such as AIG) poses a much greater systemic risk than a small, non-financial institution. Considering the costs related to central counterparty clearing it is, therefore, understandable that representatives from the non-financial industry have argued that they should be exempted from the regulation.

One alternative to exemption of non-financial users could, however, be to adjust the requirements imposed on each institution according to its systemic risk. Such an adjustment might, for instance, consider the institution's size and leverage and whether it conducts any systemically important business (for example payment service). In addition, it is possible to consider how the institution uses its OTC derivatives. It can be argued that OTC derivatives used as long term investments and/or speculatively (that is, without any actual risk being hedged) constitutes a greater systemic risk than if the instruments are used as a short term investment and to hedge risks.

Concluding remarks

As illustrated above, policymakers have a fine line to walk. On the one hand, there are strong reasons for making a requirement for central counterparty clearing as broad as possible to ensure financial stability. On the other hand, derivatives are important tools in the transfer of risk and even though the reforms are necessary and understandable, it is important to consider carefully the scope of any future regime so as not to impair that function of the OTC markets. In the long run, overly onerous regulation might negatively affect the output in the real economy.

Maria Chambers, member of Setterwalls' Aviation & Railway practice group

Tobias Johansson, member of Setterwalls' Banking & Finance practice group.

maria.chambers@setterwalls.se

tobias.johansson@setterwalls.se