

Derivatives Clearinghouses: Opportunities and Challenges

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Thank you Chairman Reed, Ranking Member Crapo, and members of the Subcommittee for the opportunity to present to you this morning my views on the important subject of derivatives clearing.

The collapse of Lehman Brothers and AIG in September of 2008 highlighted the importance of regulatory reforms that go beyond trying to prevent individual financial institutions from failing. We need reforms that act to make our markets more resilient in the face of such failures – what engineers and risk managers call “safe-fail” approaches to risk management. Well capitalized and regulated central derivatives clearinghouses to track exposures, to net trades and to novate them, to collect proper margin on a timely basis, and to absorb default risk have historically provided the best example of successful “safe-fail” risk management in the derivatives industry.

Compare the collapse of the large hedge fund Amaranth in 2006 with the collapse of AIG in 2008. Both were laid low by derivatives exposures. Yet whereas the failure of Amaranth caused barely a ripple in the markets, owing to its exposures having been in centrally cleared exchange-traded natural gas futures contracts, the failure of AIG precipitated justifiable concerns of widespread market contagion that ultimately required a massive and enormously controversial government intervention and bailout to contain. Had AIG been building derivatives exposures on-exchange rather than in the OTC markets, its reckless speculation would have been brought to a halt much earlier owing to minute-by-minute exposure-tracking in the clearinghouse and unambiguous mark-to-market and margining rules. The long, drawn-out wrangling between AIG and Goldman Sachs over the collateral required to cover AIG’s deteriorating derivatives positions would never

have been possible had a clearinghouse stood between the two. Furthermore, AIG's net exposures in the marketplace would not have been the subject of rumor or surmise, but a simple matter of record at the clearinghouse.

Encouraging a shift in derivatives trading from OTC markets without central clearing to organized, government-regulated markets with central clearing is challenging, however, for two major reasons.

First, the dealers that dominate the OTC derivatives business have no incentive to accommodate such a shift. Dealers earn approximately \$55 billion in annual revenues from OTC derivatives trading. Some of the largest earn up to 16% of their revenues from such trading. The movement of such trading onto exchanges and central clearinghouses has the potential to widen market participation significantly, to increase the transparency of prices, to reduce trading costs through the netting of transactions, and in consequence to reduce the trading profits of the largest dealers materially. It is natural, therefore, that dealers should resist a movement in trading activity onto exchanges and clearinghouses. Where compelled by regulation to accommodate it, dealers can also be expected to take measures to control the structure of, and limit direct access to, the clearing operations. The use of measures such as unnecessarily high capital requirements in order to keep smaller competitors or buy-side institutions from participating directly as clearinghouse members are to be expected.

Indeed, trading infrastructure providers organized as exclusive mutual societies of major banks or dealers have a long history of restricting market access. For example, in the foreign exchange markets, the bank-controlled CLS settlement system has long resisted initiatives by exchanges and other trading service providers to pre-net trades through a third-party clearing system prior to settlement. Such netting would significantly reduce FX trading costs for many market participants, but would also reduce the settlement revenues generated by CLS and reduce the trade intermediation profits of the largest FX dealing banks. Other settlement service providers such as DTCC have no incentive to offer competition to CLS, as they are owned by the very same banks. There are therefore solid grounds for regulators to apply basic antitrust principles to the clearing and settlement businesses in order to ensure that market access is not being unduly restricted by membership or ownership limitations that cannot be justified on safety and soundness grounds.

Second, some types of derivatives contracts do not lend themselves to centralized clearing as well as others. Customized contracts, or contracts which are functionally equivalent to insurance contracts on rare events, are examples. Since it can be difficult for policymakers or regulators to determine definitively whether given contracts - new types of which are being created all the time - are well suited for central clearing, it is appropriate to put in place certain basic trading regulations in the OTC markets that will serve both to make such trading less likely to produce another AIG disaster and to encourage the movement of trading in suitable products onto central clearinghouses. Two such measures would be to apply higher regulatory capital requirements for non-cleared trades, in consequence of the higher counterparty risk implied by such trades, and to mandate trade registration and collateral management by a regulated third party, such as an exchange.

In establishing the regulatory standards for the clearing of derivatives transactions, it is imperative for lawmakers and regulators to be fully conscious of the fact that the derivatives market is effectively international, rather than national, and that it is exceptionally easy for market participants to change the legal

domicile of their trading activities with a keystroke or a simple change of trading algorithm. In this regard, I would highlight two important areas of concern.

First, the three major world authorities controlling the structure of the derivatives clearing business – the SEC, the CFTC, and the European Commission – each take a very different view of the matter. Historically, the SEC has applied what I would term the “utility” model to the industry, the CFTC has applied what I would term the “silo” model, and the European Commission has applied what I would term the “spaghetti” model. The broad benefits of each are depicted in the matrix below.

		Promotes		
		<u>Safety</u>	<u>Competition</u>	<u>Innovation</u>
Clearing Regulation Model	SEC	✓	✓	
	CFTC	✓		✓
	EU		✓	

The SEC’s utility model favors institutions operated outside the individual exchanges; in particular the DTCC in the equity markets and the OCC in the options markets. This approach has generally performed well in terms of safety and soundness, and in encouraging competition among exchanges. It performs poorly, however, in terms of encouraging innovation in clearing and settlement services.

The CFTC’s silo model allows the individual exchanges to control their own clearinghouses. This approach has also performed well in terms of safety and soundness. The recent decision of the CME to raise margin requirements on silver trading is evidence of the model working well, in terms of the exchange placing a premium on the integrity and solvency of its clearing operations rather than trying to maximize short-term speculative trading volumes. The CFTC’s model also encourages innovation in product development in a way in which the SEC’s model does not. This is because CFTC-regulated futures exchanges can capture the benefits of product innovation in terms of generating trading volumes, whereas SEC-regulated options exchanges risk seeing trading volumes in new products migrate to other exchanges, all of which use clearing services provided by the OCC. The CFTC model, in consequence, does not promote competition from new trading venues in the same way that the SEC model does. It does, however, promote wider direct market participation in clearing systems, as demutualized exchanges have a commercial interest in expanding such access to buy-side institutions that dealers normally want to exclude. This reduces trading costs and expands market liquidity.

The European Commission’s spaghetti model, enshrined in its so-called “Code of Conduct” for the industry, compels the EU’s clearinghouses to interoperate with each other. It also encourages both exchanges and clearinghouses to compete against each other. Like the SEC’s model, however, it can be expected to dampen incentives for product innovation, as clearing competition makes it more difficult for exchanges that own clearinghouses to maximize their trading and clearing revenue returns on new product development. More importantly, this model, I believe, is not conducive to ensuring safety and soundness, as it encourages

clearinghouses to cut margin requirements and other prudential measures as a way to attract business from, or prevent business from moving to, other clearinghouses. It also injects a major element of operational risk into the business, in consequence of each clearinghouse being vulnerable to failures of technology or risk management in others.

On balance, I believe that the CFTC's model is the most appropriate for the derivatives industry, and I believe that the unworkability of the European Commission's spaghetti approach will ultimately oblige it to move back in the CFTC's direction. Although the CFTC's approach does not promote inter-exchange competition as directly as the SEC's model, it is important to note that new competitors are, in fact, entering into the futures business. ELX, founded in 2009, and NYPC, a recent joint venture between the NYSE and the DTCC which facilitates cross-margining of multiple products, are now competing with the CME in the financial futures space.

The second point I would like to make regarding the global nature of the derivatives trading industry is that certain measures to curb speculative activity being debated here in Washington are highly likely to push trading activity "off exchange" – precisely the opposite of Congress's intent. For example, a so-called Tobin Tax on futures transactions at the level being discussed last year, 2 basis points (0.02%), would be equivalent to over 400 times the CME transaction fee on Eurodollar futures. It should go without saying that a tax this large, relative to the current transaction fee on the underlying contract, would push all of this trading off the CME and into alternative jurisdictions.

Likewise, commodity market position limits, if not harmonized with UK and other national authorities, will merely push such trading outside the CFTC's jurisdiction. There is already an active regulatory arbitrage on oil and natural gas futures between the CME's Nymex exchange, which trades such contracts under CFTC regulation, and the Intercontinental Exchange (ICE), which trades such contracts under FSA regulation in London. We have seen indications of movement in trading from Nymex to ICE in line with market perceptions of the likelihood of such limits being imposed in the United States. In short, we must be extraordinarily cautious not to undermine Congress's worthy goal of bringing more derivatives trading under the purview of US-regulated exchanges and clearinghouses by inadvertently providing major market participants incentives to do precisely the opposite.

Thank you, Mr. Chairman, for the opportunity to present my views today on this important issue.