Ignorance in action

Many of the proposed reforms in derivatives market regulation were driven by politics rather than economics. This could lead to an additional source of systemic risk and less effective risk management among end-users, argues ***David Rowe***

It has been said that nothing is more frightening than ignorance in action. If so, then some aspects of the new global consensus on the reform of derivatives market regulation should frighten us to death. Sadly, much of the pressure for regulatory change has been driven by political rather than economic motivations. In all too many cases, secondary effects have been brushed aside or simply not recognised.

A major characteristic of the new conventional wisdom of derivatives regulation is that clearing is inherently safer in all respects than the bilateral, over-the-counter market. It is undoubtedly true that fully margined central clearing counterparties have many risk-reducing features. Most legal jurisdictions now recognise the right to net the gains and losses across multiple trades between two common counterparties. When trades are executed in the OTC market, such netting is confined to individual bilateral pools of transactions.

The biggest advantage of central counterparties (CCPs) is that the clearing house becomes the legal counterparty to both sides of trades between any two members. This allows netting on a much broader multilateral basis, since it applies across all the trades a member clears on the CCP. Such multilateral netting reduces total credit exposure in the system – it effectively allows losses on trades with Member A to be netted against gains on transactions with Member B.

A potential downside of this is that by establishing a single choke-point in the system, such a structure opens the possibility of an even worse systemic crisis should unforeseen events or an operational failure bring down the CCP itself. Such failures are rare, but they are not unprecedented. In effect, reducing bilateral credit risk creates highly concentrated exposure to operational risk. Contrary to what some seem to believe, forcing most high volume derivatives contracts on to a CCP is not a comprehensive means for controlling systemic risk.

The second widely accepted regulatory presumption is that remaining OTC transactions need to be fully cash collateralised in a manner similar to the methods employed on an exchange. This effectively outlaws the right of institutions to agree to assume the bilateral credit exposure implicit in a term derivatives agreement. Requiring cash collateralisation of OTC derivatives, however, is more than just an imposition on freedom of contract – it will also result in a substantial reduction in business use of these risk management tools.

When derivatives are used to hedge an unfavourable event, an outcome that favours the hedger's underlying business often does not generate immediate cash equivalent to the full mark-to-market loss on the hedge. For example, a decline in jet fuel prices is favourable to the future operating margins of an airline, but these benefits will only materialise as cash when better margins accrue into higher earnings. Forcing cash collateralisation of the full mark-to-market loss on an airline's hedge against rising fuel prices can place a significant burden on its cash position when prices fall. The inevitable result of imposing this requirement on all OTC derivatives will be to reduce their use and lead to less effective management of economic risks.

I am convinced Lehman Brothers did not present anything like the level of inherent systemic risk that many claim it did. What was problematic was the opacity of its positions, both to regulators and even to its own staff. The most important thing forcing most volume derivatives on to exchanges and CCPs will achieve is a standardised electronic representation of all such trades. This will result in a significant improvement in market transparency.

There is an easy and foolproof way to create similar transparency in the OTC derivatives market without destroying the practical effectiveness of these instruments by requiring cash collateralisation. The government can simply legislate that all such trades must be reported in a standardised electronic form to a non-public, centralised database, and that the terms and conditions so reported will constitute the legally enforceable rights and obligations of the reporting entity to its counterparty.

A potential loss of the legal right to enforce their claims in court would ensure all participants reported on an accurate and timely basis. Regulators should have privileged access to this centralised database to evaluate current and potential future credit exposure among major market players and to conduct stress tests.

Such a database also would allow supervisors to develop contingent resolution plans without generating self-fulfilling market signals. Such an initiative would improve our capacity for macro-prudential regulation without undermining the valuable role derivatives have played in hedging economic risk. Finally, and perhaps most important, the standardisation such reporting creates would enable much-improved counterparty credit risk management within the individual reporting firms themselves. ■

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