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The standard-bearer

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Regulators have turned their attention from emergency actions designed to restore stability in the capital markets to the debate regarding regulatory reform. Much of this debate will be shaped by an almost visceral desire on the part of policymakers to address areas of the markets that may have not been particularly well understood, but have nonetheless been identified as having contributed to the financial crisis or having contributed to 'systemic risk'.

For example, following announcements by AIG and various monoline insurers regarding their exposures to credit derivatives, shell-shocked investors were quick to blame credit derivatives, especially credit default swaps (CDSs), for contributing to the financial crisis. Market participants and regulators alike were troubled by the fact that there was little actual awareness of the actual size of the credit derivatives market. The CDS market has been referred to as a 'black hole'. Last year, when insurer AIG first disclosed it held more than $440bn (a number later proven to have been overstated) of credit swap trades linked to CDS, market participants realised that a lack of transparency had obscured the actual size of CDS exposures. Historically, CDSs trade over the counter and between institutions. CDSs tend to be highly customised. As a result, it may be difficult to assess market value and to quantify actual CDS exposure. Regulators recently have taken steps to move standardised CDSs to central counterparties, or CCPs. As regulated entities, CCPs address one of the fundamental concerns with credit derivatives – that is, counterparty risk that contributes to systemic risk. The use of CCPs for standardised CDSs is intended to facilitate greater market transparency and permit regulators to monitor and assess exposures.

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In May 2009, Treasury Secretary Geithner introduced the administration's proposed new framework for regulating all derivatives, including OTC derivatives. Geithner noted that the objectives of the framework were four-fold: to prevent activities threatening the stability of the financial system; to promote market efficiency and transparency; to deter market manipulation, fraud and similar abuses; and to ensure that OTC derivatives are not marketed inappropriately to 'unsophisticated' retail investors. The plan included statutory authority to mandate the central clearing of all standardised OTC derivatives through regulated CCPs. Derivatives dealers and firms with significant derivatives exposures would be subject to a strict supervisory regime that would include initial margin requirements, reporting requirements, business conduct standards and conservative capital requirements. Under Geithner's proposal, both the SEC and the CFTC would have authority to regulate the OTC derivatives markets and the CCPs. Implementing this proposal would require extensive amendments to the Commodity Exchange Act and to various securities regulations. Market participants would become subject to reporting and record keeping requirements for all (standardised and customised) OTC derivatives. CCPs and central trade repositories would be required to aggregate and report data on open derivatives positions and trading volumes. Individual counterparty data, including information on trades and positions, would be required to be made available to regulators.

In the weeks that have passed since Geithner's announcement, industry groups and industry participants have been quick to recognise that reform of financial industry regulation is both needed and inevitable. The derivatives industry has pointed to a number of important steps that have already been taken toward self-regulation and increased transparency. For example, industry participants have committed to recording trades in a trade repository; continuing to make operational improvements relating to matching trades, increasing automation, reducing trade confirmation backlogs; implementing industry best practices; and strengthening counterparty risk management through reconciliation of portfolios and through implementation of a mechanism for resolution of valuation disputes. However, legislators, eager to protect their constituents from what Warren Buffett has referred to as "weapons of mass destruction", are unlikely to be placated by industry best practices and more attempts at self-regulation.

As we move from Geithner's aspirational statements toward the invariably imperfect process of hammering out the details of regulation, a number of questions arise. Last week, the House Financial Services Committee held hearings on 'The Effective Regulation of the Over-the-Counter Derivatives Market' and heard testimony from a number of industry participants. Participants were quick to point out that derivatives do not 'create' risk – they merely serve to transfer or allocate risk. As such, derivatives serve an important and useful function in the capital markets. Moreover, a large part of the value of a derivative instrument depends on its customisation, or, understood differently, on the ability of the parties to a derivatives contract to custom-tailor an instrument so that it addresses the specific risks that an end-user seeks to mitigate. Customised OTC derivatives developed to fill a need not addressed by standardised contracts or other financial products. Derivatives dealers also need to be able to 'customise' or tailor the collateral or other requirements associated with OTC derivatives contracts. It became clear from the hearings that definitions, or rather a definition, will remain at the crux of the debate for the next several months. Customised, or non-standardised, derivatives would not be required to be cleared through a CCP. And, in fact, clearing entities note that they are not equipped to clear anything other than 'standardised' instruments. But, who is to say what's 'standard'?

Webster's dictionary defines 'standard' as something that is "regularly and widely used, available or supplied". In a secondary definition, the dictionary notes that 'standard' includes something "having recognized and permanent value" or something "substantially uniform and well established". To date, regulators have said that to the extent that a CCP approves an OTC derivative for clearance through its system, that OTC derivative will be presumed to be 'standardised'. Other legislators have noted that market participants will know which OTC derivatives are 'standardised' and which are not. This is in many respects vaguely reminiscent of Justice Stewart's "you'll know it when you see it" obscenity test. Industry participants, including CCPs, will need a more precise definition of 'standardised' OTC derivatives in order for any of the suggested reforms to be properly and fully evaluated, and for their potential impacts to be assessed. At the very least, it is likely that the current proposals would lead to an increase in the overall cost of OTC derivatives that are deemed 'customised'. It is also likely that misdiagnosing the problems associated with the derivatives market may lead to regulation that will make the US markets uncompetitive and increasingly irrelevant.

Debates regarding derivatives and other 'complex' financial products seem to ignore the basic principles of supply and demand – products develop to fill a need. The media has blamed financial innovation and financial engineering for contributing to the financial crisis. There have been suggestions that financial intermediaries created products only for the sake of having something that appeared innovative to offer clients. Innovation that works is rarely innovation for innovation's sake. The depth of the derivatives market, particularly the 'customised' derivatives market, would suggest that it has developed out of necessity. Risks generally are not 'standardised', and the instruments used to hedge against them, if they are to be effective, typically also aren't standardised. ■

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