Though over the counter (OTC) markets have successfully exchanged financial contracts for decades, they played a prominent role in causing and aggravating the ongoing crisis. After all, most of the toxic assets plaguing financial institutions were purchased in OTC markets.

Regulatory reforms proposed in the United States in March 2009 by Treasury Secretary Geithner for approval by the Congress involve significant changes to legislation governing derivatives trading, especially the trading infrastructure of OTC markets. The objective of these reforms appears to have been to reduce systemic risk in the financial sector and improving overall regulatory oversight.

Under the proposed reforms, mature and standardized derivatives such as the credit default swaps (CDS) will be traded with a centralized counterparty (CCP) or an exchange. Trades in such derivatives will thus be recorded on a timely basis. Regulators will gain unfettered access to information on prices, volumes and exposures from the centralized
counterparties, but it is unclear if the proposals will require that such information be made public. While some aggregate information will likely be disseminated to all market participants, such as the recent data published by the Depository Trust and Clearing Corp (DTCC) on all live CDS positions, full transparency is being required only for regulatory usage.

Since the announcement of the reform plans, index and single-name CDS trades have moved to centralized counterparty (ICE Trust) and clearing (DTCC). The terms of the standard single-name CDS contract have also been altered so that a fixed premium (100bps for investment grade names and 500bps for junk names) will be paid during the life of the contract, regardless of the fair market premium, and any residual premium will be settled through an upfront exchange between the buyer and the seller. This “big-bang” protocol will enable the CCP to close out otherwise equivalent long and short positions with counterparty by simply exchanging cash up-front and leave no residual counterparty risk. Indeed, such protocol had always existed for index CDS trades and worked seamlessly. While the industry has embraced these changes fully, it continues to resist regulatory calls to move the CDS on to exchange-traded platforms, arguing that these products do not yet have sufficient participation outside of the inter-dealer market to succeed on an exchange. Exchange trading might also reduce dealer margins in the CDS market.

Overall, we applaud these proposals and changes and the stated objectives of limiting systemic risk, opacity, manipulation and fraud in the derivatives business. But we urge the Treasury to push for even further transparency in the OTC markets, as explained below, recognizing that many financial products such as the customized or “bespoke” collateralized debt and loan obligations (CDOs and CLOs) will not be amenable to centralized clearing or exchange
trading. The OTC markets will surely exist if only to trade these remaining contracts. It might seem that these bespoke products can be ignored from a risk point of view, however nearly all the problem legacy assets are of this type and these we now know are extremely risky systemically.

To explain why further transparency is required, let us first understand the key role played by counterparty risk in creating systemic risk.

Most financial contracts are arrangements between two parties to deliver goods or cash in amounts and at times that depend upon uncertain future events. Designed appropriately, financial contracts facilitate risk-sharing in the economy. There may be many risks in such contracts, but one additional risk to be evaluated at the time of contracting is the risk that the counterparty will not fulfill its future obligations. This counterparty risk is difficult to evaluate because the exposure of the counterparty to various risks is generally not public information. This opacity of exposures leads to an important risk spillover – an “externality” in the language of economists – that the counterparty risk on one contract will be increased if the counterparty agrees to the same contract with another agent because the second contract increases the probability that the counterparty will be unable to perform on the first one. Put simply, the risk on one deal depends on what else is done but in OTC markets it is not at all transparent what else is being done. This makes it likely that excessively large positions will be built by some institutions without the full knowledge of other market participants. If these institutions were to default, their counterparties would also incur significant losses, creating systemic risk in the economy.
For example, in September 2008, it became known that A.I.G.’s liquidity position was inadequate given that it had written credit default swaps (bespoke CDS) for many investors guaranteeing protection against default on mortgage-backed products. Each investor realized that the value of A.I.G.’s protection was dramatically reduced on its individual guarantee. Investors demanded increased collateral – essentially posting of extra cash – which A.I.G. was unable to provide and the Treasury had to take over A.I.G. The counterparty risks were so widespread globally that a default would probably have spurred many other defaults generating a downward spiral.

The A.I.G. example illustrates well the cost that large OTC exposures can impose on the system. But, more importantly, it also raises the question of whether A.I.G.’s true risk as a counterparty was reflected by investors in prices and risk controls – such as collateral or margining arrangements – for protections they purchased from A.I.G. The opacity of the OTC markets in which these credit derivatives trade was primarily responsible for allowing the buildup of such large exposures in the first place. While positions in derivatives that are moved to exchange trading will naturally be subject to capital requirements, the real risk is that inadequately capitalized positions might build up in derivatives that continue to trade in opaque OTC markets.

To prevent systemically important exposures from building up again in the future, we suggest that regulators should extend the push for transparency to all derivatives. In particular, all OTC markets should be subject to minimum levels of transparency. Transactions should be
public information. Suppose every trade was posted on a particular internet site within a reasonable time of execution – as required by the NASD for all OTC trades in corporate bonds which must be reported on the TRACE. Counterparties could then verify the accuracy of the contract. Those interested could determine the volume of contracts of any form and by any counterparty. Vendors would presumably make a profitable business compiling, analyzing and selling the complex data from this source. Counterparty risk could be more accurately priced and collateral arrangements could be based on this information. Counterparties who sold excessive protection would find their prices falling for both old and new contracts. Counterparties would have incentives to limit exposures and to advertise this to other market participants. Although the risk spillover is not as completely eliminated as with a centralized counterparty, it would be substantially reduced by this type of transparency. Investors, regulators and even the financial institutions themselves would have a much better way to analyze and hedge the true risk of their exposures.

An alternate scheme is to impose higher capital requirements on OTC derivative positions. In principle, this would also safeguard against systemic risks building up in OTC markets. On balance, we prefer the transparency legislation laid out above for two reasons. First, OTC contracts are inherently complex as they are customized for specific purposes. Putting the entire burden of figuring out the right capital requirements for complex contracts on regulators, rather than providing the necessary information to market participants to price correctly the counterparty risk, and thereby, the OTC contract itself, seems unfortunate. Second, being able to charge capital requirements on OTC contracts implicitly assumes a certain level of transparency of these positions, at least to the regulator, through a centralized registry or disclosure.
requirement; the incremental cost of providing that information to market participants seems small. Of course, some capital requirements would be warranted even with the transparency legislation in place.

Large players will naturally resist such a transparency legislation. They will argue that it inhibits financial innovation, as they have repeatedly done in the past. But such resistance needs to be balanced against the systemic losses when large players fail.

Centralized counterparty or exchange trading of standard derivative products is an important step forward. But regulators must look to fighting the next war, not just the last one. Such transparency requirements would discourage players from cloning OTC varieties of standard products just to reduce capital requirements. Furthermore, when some OTC market becomes large and suitable for exchange trading, transparency standards would enable smooth migration to centralized trading.

And, finally, huge losses announced by the Royal Bank of Scotland and State Street earlier this year suggest that even now we do not know exactly what toxic assets are held by which banks. With legislation in place that requires transparency also in the remaining, less standardized OTC markets, we would eventually know these positions. Market participants would apply appropriate risk controls in OTC trades, systemic risk would be lower, and even if it were to materialize, regulators would be less compromised in dealing with failures of large institutions. Overall, we would have a smoothly functioning financial market capable of actively developing – and robustly managing – the next financial innovation.