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Statement of the Shadow Financial Regulatory Committee on

Derivatives, Clearing and Exchange-Trading

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As an outgrowth of the financial market crisis and the accompanying lack of transparency of derivatives exposures, there is increasing interest in the regulation of derivatives. Lack of transparency about counterparty exposures and risk is potentially an important cause of systemic risk. To the extent that derivatives contracts are relatively standardized, these instruments should be centrally cleared to minimize the propagation of risk throughout the financial system. These cleared, standardized contracts should be subject to post-trade price reporting in order to facilitate competition in the trading process. This also heightens information about valuations, thereby helping to control systemic risk and potentially improving market pricing. Analogously, public reporting of bond prices in the TRACE (Trading Reporting and Compliance Engine) system has been an important innovation in over-the-counter (OTC) bond trading that resulted in higher quality markets.

Exchange-trading of standardized contracts also should be encouraged to enhance competition by allowing investors to trade directly with one another rather than solely with dealers. This would improve both the quality of market valuations and trading efficiency, thereby helping to mitigate systemic risk. Tiered capital and margin requirements in which smaller capital charges for financial institutions and lower margin requirements for issuers and end-users of cleared instruments should be utilized to provide dealers and end-users

of cleared instruments should be utilized to provide dealers and end-users incentives to use instruments subject to clearing. Analogously, even more favorable standards should be used for those subject to exchange trading.

The Shadow Committee, however, is opposed to the efforts of some policymakers to force clearing and/or exchange-trading for all instruments—whether by regulatory fiat or by excessive capital charges for OTC transactions. Derivatives are important tools in our financial system and it is important to encourage innovations in instrument design. Many of the most important standard derivatives instruments started out as specialized innovations. Even if these might represent only a small percentage of the activity at first, such non-standardized innovations can become important to the value of derivatives trading for the economy over time. Many interest rate and foreign exchange swaps have become standardized, but quite a few credit default swaps (CDS) would continue to be customized because of the importance of the identity of the reference name and even the specific reference bond to the payoff structure of the CDS.

While the Committee is supportive of a substantial shift towards clearing in standardized instruments, it is concerned in the current regulatory debate about whether policymakers have adequately understood the importance of the risk management of the clearinghouse to the integrity of the financial system. Because of the central role of clearinghouses as the counterparty on all cleared instruments, their viability would be central to the operation and organization of the financial system. The design of collateral and margin requirements would be crucial in the absence of continuous and accurate margining. Because clearinghouses that operated in other contexts fared well during the current financial crisis, policymakers are not predisposed towards recognizing the systemic risks associated with this model. But one should be careful not to extrapolate the favorable experience without a dose of caution and healthy skepticism, especially in light of the greater contemplated role for the clearinghouses.

Current reports indicate that the Senate bill may ban major Wall Street institutions from trading in derivatives. We anticipate that this would reduce liquidity in the markets, widening spreads and increasing funding costs to end-users. End-users would be forced to shift derivatives activities to higher cost venues, whether domestically or off-shore.

Accurate pricing of credit default swaps helps the market as well as regulators to assess a borrower's creditworthiness. Trading by speculators and major financial intermediaries enhances price discovery in derivatives market and in many contexts these are natural and needed counterparties for the hedger. Hedging and speculation are crucial activities in our financial system that should not be limited.