

Which Ideas Work for CDS?

Creation of a central counterparty for CDS

The rapid growth of the CDS market has presented operational, infrastructural and risk management challenges for market participants. Since 2005, the industry has worked successfully with the NY Federal Reserve and other federal regulators on various voluntary initiatives to reduce risk and improve the infrastructure of the CDS market.

These initiatives have succeeded in accomplishing a number important objectives: reducing the number of unconfirmed trades; facilitating the orderly settlement of CDS on significant companies that had become insolvent; and significantly reducing the gross outstanding notional amount of redundant CDS positions.

Among the most important of these initiatives, which is very near completion, is the creation of a CDS clearinghouse. This initiative will (i) significantly mitigate many of the counterparty credit risks, capital inefficiencies and operational challenges associated with CDS currently; (ii) provide greater transparency to regulators; and (iii) potentially reduce the amount leverage that CDS market participants may assume. The clearinghouse is expected to be up and running by the end of this year as a fully regulated financial institution.

Oversight of CDS

All of the leading intermediaries in the CDS market are banks or members of bank or financial holding companies and are currently subject to comprehensive regulation with respect to their CDS and other OTC activities. To the extent that gaps exist in federal oversight of CDS (such as gaps in the oversight of AIG), these gaps should be addressed in a manner that is effective and does not undermine the efficacy of the CDS market.

Legislative principles

The challenges facing today's CDS market relate principally to capital adequacy and risk management and the systemic risks associated with these challenges. As a result, any legislative framework for CDS should focus on effective prudential oversight by a supervisor with the authorities and tools necessary to address systemic risk issues.

In order to promote effective oversight for the purpose of mitigating systemic risks, it is important that the federal regulator of CDS have transparent access to the positions and exposures of all systemically significant participants in the CDS market.

In order to prevent gaps in oversight, duplication, inconsistency and jurisdiction conflicts, oversight of CDS should be consolidated in a single federal regulator. Recognizing the relationship between the CDS market and the debt securities market, however, it is appropriate to maintain the SEC's existing authorities with respect to fraud and market manipulation.

Given the global character of the CDS market, it is also important that U.S. regulation be coordinated with foreign regulation, particularly in the European Union.

Which Ideas Don't Work?

Mandating clearing of CDS

The industry began work in 2007 to establish a clearinghouse for CDS transactions. The leading CDS dealers, all of whom are regulated by the Federal Reserve, have committed to the Federal Reserve to begin clearing their positions in the largest and most liquid CDS contracts at the earliest possible time. The industry uniformly supports the Federal Reserve's use of its regulatory authority to require that dealers clear their CDS positions in appropriate cases.

The industry does not believe, however, that a statutory mandate for the clearing of CDS would be appropriate, workable or necessary. Any such mandate could have adverse consequences that would be avoided by relying on the Federal Reserve to establish clearing requirements on a dynamic basis as these products and markets evolve.

As a threshold matter, not all CDS are suitable for clearing, or can be cleared without presenting unacceptable operational or risk management challenges for the clearinghouse. Similarly, participation in a clearinghouse will not be appropriate for all market participants. Certain CDS are intentionally customized to achieve transaction-specific objectives. Other CDS will not have matured to a point where market conventions have evolved to the level of standardization that is necessary to support clearing. While other CDS will not trade in sufficiently large numbers to warrant a clearing solution.

As a result, a general statutory mandate that CDS transactions be cleared would harm the CDS market by preventing market participants from entering into privately negotiated or customized contracts and by precluding innovation through the development of new contracts whose terms will need to evolve over time before they reach a level of maturity that will facilitate a clearing solution.

A statutory mandate that purports to distinguish between CDS that would or would not be subject to a clearing mandate would only promote legal uncertainty and chill innovation and would not further any objective that could not be more effectively accomplished by allowing this authority to be exercised on a dynamic basis by the Federal Reserve, based on a contemporaneous analysis of the market, the relevant product and associated risks.

Mandating exchange trading of CDS

Like clearing, exchange trading can provide benefits for mature, standardized derivatives products. For the reasons outlined above in the case of a mandated clearing solution, however, an exchange-trading mandate would also be inappropriate and detrimental to the market and its future development.

Experience over the past several years demonstrates that different trading environments are necessary in order to meet the differing objectives and execution strategies of market participants with respect to different products. Some products trade effectively in exchange and non-exchange markets. Some market segments, such as large wholesale transactions, generally do not lend themselves to exchange trading. Some product markets, such as the market for debt securities, do not trade on exchange markets at all.

Moreover, CDS do not have to be traded on an exchange in order to achieve the benefits of clearing or other regulatory or market improvements.