

Testimony of Christian A. Johnson
Professor, S.J. Quinney College of Law, The University of Utah
Before the Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
of the United States House of Representatives Committee on Financial
Services
“Clearing Standardized OTC Derivatives”
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Mr. Chairman and Members of the Subcommittee:

My name is Christian Johnson. Throughout my career I have been involved in the capital markets and the OTC derivatives market in particular. As a lawyer, I have worked for Milbank Tweed in New York and Mayer Brown & Platt in Chicago. For the past fourteen years I have been a law professor. My writing and research focus has been primarily on OTC derivatives.

Secretary Geithner’s articulation (and proposals) on May 13, 2009 of the U.S. Treasury’s objectives of regulatory reform of the OTC derivatives market provide a solid foundation to center regulation of the OTC derivatives market. My focus today is on the practicalities and complexities of converting these objectives into statute and regulation and the need to proceed carefully in order to preserve U.S. leadership in the world’s capital markets. I believe that Congress should proceed in efforts to reduce counterparty credit risk. However, I believe that the effort to clear all OTC derivatives through regulated central counterparties (CCPs) should be done slowly and methodically and with substantial input from OTC derivatives market participants. Congress should be aware that requiring OTC derivatives to be cleared through CCPs represents a seismic and unproven shift as to how OTC derivatives are traded, processed, assessed and function.

Requiring OTC derivatives to be cleared without laying a proper, practical and acceptable regulatory framework risks harming the competitive position of U.S. financial institutions, driving the OTC derivatives market overseas, and limiting the ability of U.S. companies to hedge their market risks. Currently, the proposed framework for clearing OTC derivatives is skeletal at best, resulting in a virtual vacuum of key information necessary to access how clearing would work for OTC derivatives. In addition, many of the proposals base their feasibility and plans upon the relatively limited successes in the credit default swap market, a narrow and idiosyncratic slice of the OTC derivatives market.

Clearing OTC derivatives is not a new concept. In fact, clearing OTC derivatives to reduce credit risk has always been the “holy grail” of the derivatives industry. Credit risk is so important that the initial decision to hedge using OTC derivatives over exchange-traded derivatives will often center on weighing credit risk against the benefits of customizing the transaction. Unfortunately, the historical compelling advantage of reducing credit risk through clearing has been insufficient to overcome the enormous practical constraints and historical practical, regulatory, and competitive issues in clearing OTC derivatives.

History of OTC Derivative Clearing

Until recently, the U.S. regulatory structure effectively prevented clearing OTC derivatives. In its 1989 policy statement,¹ the CFTC agreed not to regulate OTC derivatives provided that the transactions were individually tailored and that there was no exchange-style offset or clearing. In 1993, clearing was further discouraged when the CFTC promulgated regulations that exempted OTC derivatives from CFTC jurisdiction provided that

¹ CFTC, Policy Statement Concerning Swap Transactions, 54 FR 30694-01, 1989 WL 278866(F.R.) (July 21, 1989).

transactions were not “*standardized* as to their material terms”.² Even the Commodity Futures Modernization Act passed in 2000 left regulatory barriers to clearing OTC derivatives.

This regulatory history is important to understand because the OTC derivatives industry developed its trading and operational infrastructure to *not clear* OTC derivatives. World-wide, the industry has spent three decades developing processes to trade, collateralize and terminate OTC derivatives without clearing. Because of this history, clearing OTC derivatives will require significant resources and time on the part of dealers and endusers to put into place new products, systems, procedures, back offices and processes to take full advantage of clearing.

Outside the United States, there have been various attempts to clear OTC derivatives. Back in the late nineties, the London Stock Exchange attempted to clear plain vanilla interest rate swaps. There were also similar efforts in Sweden by OM Stockholm. More recently, the Singapore Stock Exchange clears the small and specialized areas of OTC paper oil swaps and foreign freight agreements through its SGX AsiaClear facility.

The failure of the OTC derivatives industry to develop ways to clear OTC derivatives without Federal regulation is troubling. If the benefits of clearing are so compelling as to require the massive market and regulatory overhaul being contemplated, the market should have adopted clearing already. A key factor in such failure (as explained above) involves the regulatory turf war over jurisdiction and regulation of the industry, resulting in requirements that OTC derivatives not be standardized and cleared. Another factor for such failure is that clearing OTC derivatives may be so difficult, cumbersome and costly that it has outweighed

² 17 CFR Part 35.

the long term benefits of reducing counterparty and systemic credit risks. Finally, because OTC derivative dealers have developed infrastructure based on **not clearing** derivatives, they may be reluctant to abandon such a system that might undermine their role in the OTC derivatives market.

“Standardized OTC Derivatives”

A key issue to successful clearing is that the transactions should be standardized as fully as possible in order to develop the volume and efficiencies necessary to clear. Exchange traded derivatives can be cleared easily because they are completely standardized except as to price (i.e. maturity, quantity, quality, notional amount). Geithner’s May 13th proposal, in contrast to some proposals, only calls for clearing “standardized OTC derivatives”, something that at first blush appears to be an oxymoron. OTC derivatives were developed in response to market demand for derivatives that could be customized beyond what was offered in the exchange-traded market.

The key unanswered question in Geithner’s proposal is when does an OTC derivative become sufficiently standardized that it is both “required” to be cleared by regulation, and, as a practical matter, is capable of being cleared. Geithner’s Letter appears to envision a continuum in which “standardized OTC derivatives” are less standardized than futures but more standardized than “customized OTC derivatives.” **See Exhibit 1.** The only concrete guidance as to when a transaction is standardized is “if an OTC derivative is accepted for clearing by one or more fully regulated CCPs, it should create a presumption that it is a standardized contract and thus required to be cleared.” This guidance was coupled in the Geithner letter with an anti-abuse rule that provides that “customized OTC derivatives are not used solely as a means to avoid using a CCP.”

In determining whether dealers will trade “standardized OTC derivatives” (subject to clearing) or “customized OTC derivatives”, the benefits and costs to the dealer of trading standardized OTC derivatives should be considered (**see exhibit 1 - the motivation continuum**). If the dealer’s counterparty is not creditworthy, there will be a strong incentive to clear that trade through a CCP to avoid any credit risk. The dealer will be much less motivated to clear a trade if his counterparty is creditworthy or he is fully collateralized. It is possible to envision a scenario in which the dealer will “dump” his less creditworthy counterparties on the clearinghouse and trade outside with his creditworthy customer through customized derivatives

A second factor is the extent to which a particular market or type of transaction is highly specialized and “dominated” by a particular dealer or group of dealers or whether such trading is widespread and essentially “commoditized”. If a particular dealer is a principal market maker, he may be more likely to control his trading (and thus his profitability) by trading through customized OTC derivatives. If the market is sufficiently important, the dealer may actually move such trading overseas to avoid standardization and clearing. In contrast, the market may actually require a dealer to clear his trades in a highly competitive market such as interest rates.

A third factor may relate to efficiencies and cost reductions associated with clearing for the dealer. To the extent that it is more efficient, less costly or easier to clear a trade, the more likely the dealer will be to clear. In contrast, if clearing creates additional costs, regulation or inefficiencies, the dealer may prefer to continue with the status quo and trade customized OTC derivatives. The worst case scenario may actually force a dealer overseas if he finds the U.S. regulatory structure too cumbersome, costly or uncertain.

Before one can discuss whether clearing will accommodate the OTC derivatives market, the parameters as to what constitutes a “standardized OTC derivative” need to be established. This is compounded by the problem that it has yet to be decided by Congress whether regulators, market participants, clearinghouses, or others parties, will make that determination. It is clear to me however, that we risk injuring both the domestic OTC derivatives market and our U.S. derivative dealers by making these decisions without significant market input.

Product Complexity

A primary reason why OTC derivatives are not currently being cleared is due to their inherent complexity and non-standardized terms. There are currently essentially only three types of exchange-traded derivative products: futures, options on futures, and options. Each of these products share standardized features that are included in the transaction structure, regardless of what market the transactions are hedging. In contrast, the OTC derivatives market is typically divided into numerous basic products or structures such as forwards, swaps, options, caps, floors, etc., each of which could be infinitely divided into customized structures and all with a variety of cash flows very distinct from exchange traded derivatives. Each of these structures is often individually modified, customized or tailored for an individual market. The credit default swap market and the power/energy markets are examples of OTC derivative areas where market practices and structures have been developed that may differ from other OTC derivatives markets based on their particular hedging needs.

Size of OTC Derivatives Market.

The sheer size of the OTC derivatives market will make the institutionalization of clearing difficult and time consuming. The Bank of International Settlements estimate that the notional amount outstanding at the end of 2008 was \$592 trillion, with gross market values of approximately \$34 trillion. The OCC estimates that U.S. banks have derivatives trades of approximately \$170 Trillion of notional amount outstanding. Although there is little information as to the sheer number of outstanding transactions, bankruptcy files show that Lehman Brothers alone had approximately 930,000 OTC derivatives transactions with thousands of customers at the time of its insolvency. **Exhibit 2** provides a chart showing the composition of the market.

The progress made in clearing credit default swaps is illustrative of both the possibilities and difficulties of clearing OTC derivatives, although the widespread actual clearing of new credit default swaps is still a work in progress. A key factor in this progress is the relatively small size of the credit default swap market in comparison with the OTC derivatives market in general. **See Exhibit 2.** In addition, credit default swaps are typically traded more aggressively and are more uniform than other types of OTC derivatives due to the trading appetite of dealers, endusers and hedge funds. It would be difficult to replicate the quick progress made for the bigger trading areas such as interest rates or currencies.

Another key factor for the focus on credit default swaps has been justifiable concerns about the high volatility and possible losses that can be suffered, making credit default swaps a clear target for risk reduction. Regulators appear to have been focusing initially on one of the riskiest classes of OTC derivative transactions. While losses can be suffered on any types of OTC derivatives, the regulators have focused initially on the most problematic.

Because the regulators are dealing with the most difficult situation, this will provide a good test case for expanding clearing to other areas.

Conclusion. The current financial crisis has highlighted problems and concerns with OTC derivatives. Secretary Geithner has made clearing standardized OTC derivatives a center point of the reforms that he would like to see enacted. Although clearing OTC derivatives would do much to limit counterparty credit risk, Congress should be careful and methodical in this approach to avoid disrupting an important and flourishing market. Moving too quickly without thoughtful and careful planning, could result in injuring a key capital market dominated by the United States. Faced with legal uncertainty or cumbersome regulation, it could drive the current OTC derivatives market overseas, taking with it important clients and expertise. Congress should proceed carefully as it attempts to impose a drastically different business model on a global industry that is currently dominated by our country's leading financial institutions.

Exhibit 1 - "Standardization" Continuum

Cleared Transactions *Fully Standardized*

Regulated Exchanges with Clearinghouse

Examples: Exchange-traded futures, options on futures and options

Key: only price is negotiated for exchange traded derivatives

Cleared/Not Cleared ?

"Standardized OTC Derivatives"

Test: *acceptance* of an OTC derivative by central counterparties (CCP) for clearing should create a standardization presumption

What are standardized terms? little or no guidance on issue

Query: What is the criteria for *acceptance*?

Example: plain vanilla interest rate swap

Not Cleared Transactions *"Customized OTC Derivatives"*

Query: how much customization will overcome presumption?

Anti-abuse Rule: can't use customization to avoid CCP

Concern: how to create legal certainty over customization issue?

Example: derivatives that conform exactly to an underlying asset or liability

Motivation Continuum

(Factors Affecting Dealer Motivation to Clear)

Motivated to Clear (Standardized)

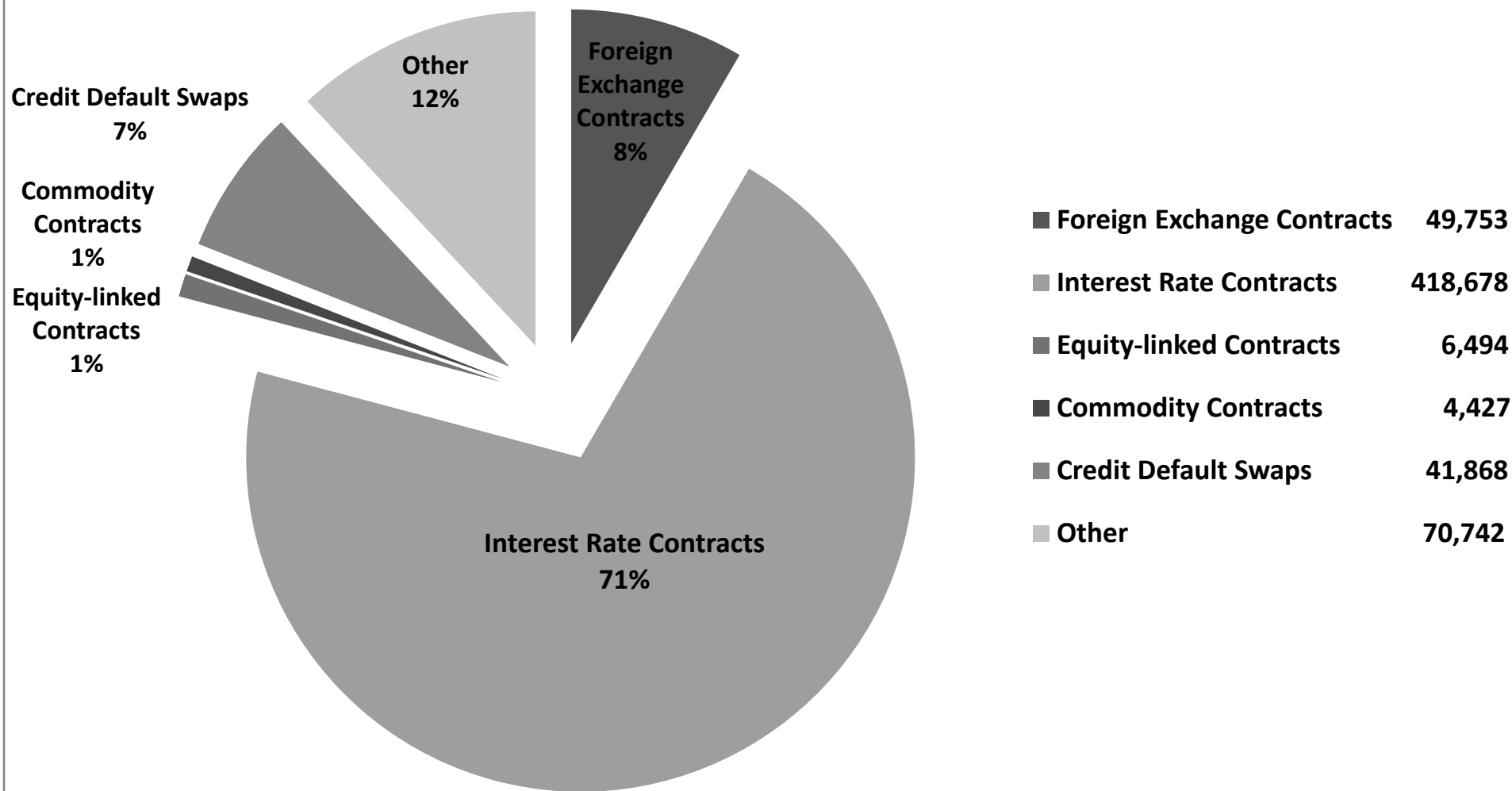
- High Counterparty Credit Risk (dumping risk)
- Market is highly competitive
- Efficiency/Profitability on exchange
- Routine/commoditized transaction
- Avoiding Federal intervention

Not Motivated to Clear (Customized)

- Low Counterparty Credit Risk (retaining good customers)
- Maintain market control
- More Profitable off exchange
- Proprietary/Confidential trades (protecting competitive position)
- Legal certainty regarding customization

Notional amounts outstanding of OTC derivatives

in billions of U.S. dollars



Source: <http://www.bis.org/statistics/otcder/dt1920a.pdf>