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A Case For Counterparty Transparency In OTC Markets

As the global economy begins to rise from its prone position, government officials, regulators and economists are racing to install financial reforms to ensure financial stability in the long run. Unfortunately, many of the proposals rely on regulators being sufficiently clever that they can restrain an extremely effective, innovative and avaricious financial industry. In this column we argue for a simple mechanism that will be self regulating for the over-the-counter (OTC) derivatives market. Reducing systemic risk in the OTC market would be an important step in ensuring overall stability of the financial system.

The signature characteristic of the OTC market is that contracts are bilateral between two counterparties who agree to payments in the future that depend on future events. The risk of such a contract includes the risk that the counterparty will not be able to pay in some cases. Often these are exactly the cases that motivate the contract in the first place. For example, American International Group agreed to insure contracts referencing sub-prime mortgages but in the event the insurance was needed, AIG was unable to deliver and taxpayers were handed the bill.

Counterparty risk is systemic risk. Because the risk on one deal depends on what else is on the counterparty’s books, there is a risk spillover from one contract to another. This is particularly difficult to analyze in OTC markets as 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.

Regulatory reforms proposed in the U.S. in May by Treasury Department Secretary Timothy Geithner suggest significant changes to legislation governing derivatives trading, especially the trading infrastructure of OTC markets. One objective of these reforms is to reduce counterparty risk by moving contracts to centralized clearing or exchanges. This development is desirable and it is already under way for the most popular contracts such as index credit default swaps and interest rate swaps. However, it is unclear what will be done with contracts that cannot or will not be moved to centralized clearing.

There has recently been widespread criticism of plans to move all OTC derivatives to a central counterparty (CCP) or exchange. This has not all come from the dealers and banks, who would naturally be expected to resist such changes, but has often come from corporations, who fear that they will lose access to these derivative contracts if they are moved to CCPs. The argument has two prongs. The first is that these corporations will suddenly be forced to post margin to a level they never had to before, and the second is that it may be too costly to buy customized products and consequently it may be difficult to obtain favorable hedge accounting benefits.

The following arguments are for those features that should be preserved. Margin should be netted so that only underwater positions have substantial margin requirements. And customized products should continue to trade OTC, which will allow standard hedge accounting, but corporations should recognize that they could obtain the same protection at a lower cost if the markets were more efficient. The key point is that OTC markets will remain even if it is legislated that some products be moved to CCPs. In fact, this segment of the market may grow over time and thereby add substantially to counterparty and systemic risk.

Alternatively, how about a solution that does not rely on regulators recognizing which products are systemically risky? OTC trades should be public information. Each trade should be posted on a public Web site along with contract details. The public information will include counterparty information and might be called counterparty transparency. Although these contracts are complex, there will be third parties who will offer to distill this information into a form that is useful to traders and risk managers. Consequently, there will be counterparty creditworthiness information that a trader can use to determine whether he wants to write a contract with a particular counterparty. The price at which the deal is written is naturally going to depend upon the credit report on this counterparty. This will provide an incentive for dealers and counterparties to keep their credit reports clean.

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. And although the risk spill-over 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.

Transparency legislation has a precedent, in an OTC market, namely for corporate bonds. All OTC trades in corporate bonds

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are required to be reported on the TRACE (Trade Reporting and Compliance Engine) by all broker-dealers who are **Financial Industry Regulatory Authority** members under a ruling of the **Securities and Exchange Commission**. Since its launch in July 2002, academic research has found that the reporting requirement has indeed improved price discovery, not just for TRACE-eligible bonds but also for other bonds, reduced transaction costs, and lowered both the market share as well as the cost advantage of large dealers. While these are all desirable outcomes of trade reporting, our push for greater transparency in OTC markets stems primarily from allowing the market to price counterparty risk more effectively. In essence, if OTC products are not standardized enough to move to CCPs, then each trade in an otherwise identical product is potentially different due to the differences in counterparty risk of involved players. Hence, there should be differences in the prices of these trades. While this renders OTC markets complex relative to centrally cleared ones, we believe that accurate pricing of counterparty risk is critical to prevent undue concentrations of risks through OTC markets.

An alternate scheme being proposed is to impose higher capital requirements on OTCs. On balance, we prefer the transparency legislation laid out above for three important 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 counterparty risk correctly, seems unfortunate.

The sheer variety of products in the OTC space implies that regulators will find the task of figuring out accurate capital requirements for each instrument onerous, and may end up implementing too harsh a solution with unintended consequences. Legislating transparency and enabling markets to price their counterparty risk appropriately appears the best way forward.

Large players will argue, as they have repeatedly done in the past, that it inhibits financial innovation and prevents them from providing customized solutions that benefit corporate clients. There is clearly some merit to this argument, but it is also true that transparency will reduce the oligopolistic advantage, both to charge higher spreads and take on hidden leverage. Hence the resistance from large players against counterparty transparency needs to be balanced against the competitive efficiency of the marketplace, and more importantly against the systemic losses inflicted on rest of the financial system and taxpayers by failures.

Centralized counterparty or exchange trading of standard derivative products is an important step forward. But regulators must look to the next battle, not just the last one. The transparency requirements we propose would discourage players from cloning OTC varieties of standard products just to reduce capital requirements. Furthermore, when the OTC market becomes large and suitable for exchange trading, transparency standards would enable smooth migration to centralized trading. In fact, traders in search of anonymity would naturally seek exchange-traded products. Overall, we would have a smoothly functioning financial market capable of actively developing—and robustly managing—the next financial innovation.

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