[Fordham Journal of Corporate & Financial Law](https://ir.lawnet.fordham.edu/jcfl)

Volume 18 | Issue 2 Article 1

2013

The Regulation of Over-The-Counter Derivatives

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Mr. Voldstad was Chief Executive Officer and Executive Director of International Swaps and Derivatives Association, Inc. from November 30, 2009 until December 31, 2011. Prior to his time at ISDA, Mr. Voldstad managed his own debt and currency hedge fund until 2007. Before that, he occupied several senior roles at Merrill Lynch, including Co-Head of Global Debt Markets, as well as at J.P. Morgan, where he served as the first head of their Global Swaps Group until 1987. Mr. Voldstad holds a J.D. from Fordham University, an M.B.A from the Amos Tuck School of Business at Dartmouth College, and a B.A. from Boston College.

VOLUME XVIII 2013 NUMBER 2

FORDHAM

JOURNAL OF
CORPORATE & FINANCIAL LAW

SYMPOSIUM

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Good morning ladies and gentlemen. I am delighted to be the keynote speaker at this symposium on the regulation of OTC derivatives. As many of you know, I retired as CEO of the International Swaps and Derivatives Association ("ISDA") at the end of 2011. While I remain an advisor to ISDA and its Board, my remarks today will strictly be my own. I take full responsibility for my opinions and hope they give one and all pause for thought and discussion as we proceed through the symposium.

While I am a graduate of Fordham Law School, I have never practiced law. My background has been in management, trading and underwriting, and analysis. As you know from the introduction, I was the first Global Head of JP Morgan's Derivatives Group, the head of Global Markets at Merrill Lynch, founder of the first AAA-rated swap company, one of a team that liquidated Long Term Capital Management in 1998 and 1999, and a manager of my own hedge fund for a number of years. I also had a valuable stint on the board of a credit reinsurance company. I should also mention I spent several years at JP Morgan as a lending officer to large companies and banks in the United States. These were all important experiences.

Today, I will talk about facts and numbers as well as the common sense needs for regulatory reform. I will suggest that we may be heading for some regulatory overkill just as we may be seeing the same with respect to bank capital requirements. I will start my remarks by

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† This transcript of Mr. Voldstad's opening remarks was edited to remove minor cadences of speech that appear awkward in writing and to provide sources and references to other explanatory materials where the editors deemed appropriate.

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discussing the role of OTC derivatives in the financial crisis. Then I'll comment on counterparty losses sustained by the U.S. banking system on OTC derivatives. Some of what I say may surprise you. In my next topic, I will discuss the present marketplace, and how much has been accomplished to make the markets safer and more efficient—to use ISDA's new tag line. I think some of this will also surprise you. Then I will look at overkill—how proposed regulations create enormous costs with very little benefit. I will offer alternatives as well. But please remember these opinions are my own.

I. OTC DERIVATIVES IN THE FINANCIAL CRISIS

Shortly after my arrival at ISDA, I published an Op-Ed in the *Financial Times*. In that piece, I argued that the main cause of the financial crisis was the US residential and commercial mortgage markets, and bad lending and underwriting decisions and practices.[1] I did not go into why this happened. We have all read explanations, and I believe blame was widespread: regulators and policymakers made terrible mistakes; Government-sponsored enterprises ("GSEs") had conflicted business models; mortgage bankers were unscrupulous in originating mortgages; rating agencies developed horrid rating practices; securities dealers structured complex mortgage products around the rating agency criteria and then actually decided they could hold them on their balance sheets once AIG Financial Products ("AIG FP") closed for business. An entire insurance industry class disappeared as they insured these toxic securities, some at the beckoning of dealers who realized that their holdings were plummeting in value, and some at the request of investors who wished to bet against mortgages. I then listed many of the dozens of companies that had ceased to exist due to one underlying cause: tremendous losses on real estate exposure.[2] Some of the exposure was taken in derivative form but a good deal of this was meant to insure dealers that already had taken the risk.

In September 2008, Lehman Brothers filed for bankruptcy.[3] Panic unfolded when money market funds broke the buck.[4] These funds had

1. Conrad Voldstad, Op-Ed., *We Have Yet to Address the Cause of the Financial Crises*, FINANCIAL TIMES, Jul. 6, 2010, *available at* http://www.ft.com/intl/cms/s/0/88b39646-890e-11df-8925-00144feab49a.html#axzz2AMckCygD.

2. *Id.*

3. *See* Andrew Ross Sorkin, *Lehman Brothers Files for Bankruptcy; Merrill is Sold*, NY TIMES, Sept. 14, 2008, http://www.nytimes.com/2008/09/15/business/

invested in cash securities issued by Lehman Brothers. At least we have not heard pundits say that derivatives caused the money fund problems. Lehman's derivatives portfolio was duly unwound. Much interdealer exposure was unwound at SwapClear, where $8 trillion was moved at a cost of around $200 million, all covered by initial margin. Dealers and other counterparties unwound positions in due course and submitted claims in bankruptcy.

Interestingly, we examined the derivatives related claims on Lehman's estate by non-financial corporations and found only five instances where claims exceeded $25 million. (We excluded a $300 million claim by the New York Giants, which had issued auction-market securities that unraveled earlier in 2008 because of the deterioration of its insurance company guarantor.) Our analysis showed the losses from derivatives hardly put the system at risk. They were not helpful, of course, but they were manageable.

Furthermore, the credit default swap ("CDS") market for Lehman as a reference entity functioned properly. There was, to be sure, some anxiety in the market until the net CDS exposure on Lehman was disclosed. It was only about $5.5 billion. Offsetting trades were matched and the high collateralization of CDS meant that no counterparty failed to meet its obligations.

Very shortly after Lehman, the New York Fed bailed out AIG. AIG FP had guaranteed, in CDS form, approximately $60 billion of subprime collateralized debt obligations ("CDOs") through the end of 2005. Unlike most financial firms, AIG FP generally did not have to post variation margin on its derivatives unless it was downgraded below AA. When the downgrade occurred, AIG had a monstrous margin call. But the margin calls were not confined to CDS. AIG also held a $50 billion plus portfolio of subprime mortgages for its bond lending business. Borrowers of these securities would not post 100% cash collateral when the securities were worth fractions of that amount. Instead, AIG had to come up with the difference. That is why there were two special purpose vehicles ("SPVs") set up by the New York Fed. Maiden Lane II contained the subprime mortgages from the bond

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15lehman.html.

4. Christopher Condon, *Reserve Primary Fund Falls Below $1 a Share*, BLOOMBERG, Sept. 16, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aycQDd9pEdCA&refer=home.

lending operation,[5] while Maiden Lane III eventually purchased the underlying bonds covered by the CDS.[6] There were no losses sustained by AIG FP's counterparties as a result of the New York Fed's actions. Interestingly, sources at AIG indicated that, as of last fall, no cash losses would have been sustained to date on the CDS had they remained in place.

As I mentioned earlier, I spent a few years on the Board of a credit reinsurer during the period that spanned the financial crisis. This gave me a great perspective on what happened in the mortgage market. With AIG FP out of business, the primary credit insurers, called monolines, rushed to take AIG FP's place. Some of this credit protection was structured for investors betting against mortgages. Far more was structured to make the underlying bonds easier to sell or to protect positions held by dealers.

I can only say I was shocked by what I saw. The entire industry has been virtually wiped out and dealer losses on exposures to monolines were staggering. ISDA did a paper last year and found provisions for losses among a dozen dealers were in excess of $50 billion with respect to monoline risk.[7] A good deal of these provisions was taken by foreign firms or US non-bank entities. The US banking system was not badly hurt at all. The losses attributed to the monolines' derivatives exposure were the largest single negative of OTC derivatives in the financial crisis. These exposures were not collateralized, similar to the practice relating to AIG FP. I thought you would all be pleased to learn that derivatives with monolines have been excluded from Dodd-Frank. So much for getting the legislation right.

II. OCC REPORTS

Each quarter, the Office of the Controller of the Currency ("OCC") produces a report on the derivatives activity of US banks. We have found the report to be very helpful. It outlines gross and net credit

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5. *See Maiden Lane Transactions,* FEDERAL RESERVE BANK OF NEW YORK, http://www.newyorkfed.org/markets/maidenlane.html.

6. *See id.*

7. *Counterparty Credit Risk Management in the US Over-the-Counter (OTC) Derivatives Markets, Part II: A Review of Monoline Exposures*, ISDA, 1 (Nov. 8, 2011), http://www2.isda.org/attachment/MzcyMQ==/Counterparty%20Credit% 20Risk %20II%20(Monolines).pdf.

exposure and the use of collateral. It also contains useful data with respect to US bank participation in the market.

From the beginning of 2007 through the third quarter of 2011, charge-offs related to OTC derivatives amounted to $4.345 billion. This includes $1.6 billion last year on a single monoline by one bank. It also includes nearly $850 million in the fourth quarter of 2008, which was presumably related to Lehman. Excluding those two amounts, charge-offs totaled only $1.9 billion, hardly a significant amount. The OCC report each quarter explains that the credit quality of participants in the OTC derivatives market is superior to Commercial and Industrial ("C&I") borrowers. Credit risk is also mitigated by netting of exposures and significant use of collateral. I need to repeat my comment with respect to monoline exposure, however. Very little of this was booked in commercial banks.

III. WHAT IS NEEDED?

If one reflects on what happened, it is not difficult to summarize what went wrong, and what is needed. First, bank supervisors did not know the risks that regulated banks were taking on. Neither they nor the banks appreciated the risks of their real estate and mortgage portfolios. Nor did they have ready information on the derivatives risk of their regulated banks. Granted, they had the ability to inspect the banks and many regulators had staff permanently residing at the banks. But they did not feel they knew what market risks were present and what entities were accumulating risk.

Second, the industry allowed large amounts of risk to go un-collateralized. I am speaking now of AIG FP and the monolines as examples. (But I know of no other examples.) Whether this would have prevented the losses from occurring is unknown. The insurance companies would not have dreamed the value of their policies could require the collateral that would be needed. If the CDS would not have been written had collateral been required, much of the risk would have remained in cash form on dealers' books.

Finally, regulators had to be sure there could be an orderly liquidation of positions in the bankruptcy of a major participant.

IV. WHAT HAS HAPPENED?

In my opinion, there has been tremendous progress even in the absence of final regulations. Much of this progress was initiated back in

2005 when the New York Fed assembled a group of global regulators and the largest dealers to set commitments on improving the safety and infrastructure of the market.[8] Derivative confirmations are now largely transmitted electronically. CDS terms have been standardized, enabling trades to be torn up. A credit event determination and auction process has been established and is working very well.

Clearing has risen dramatically among the top thirty-five or so dealers. Today, over $300 trillion of Interest Rate Swaps ("IRSs") are being cleared. Clearing is also catching on in the CDS marketplace. There, over 75% of the market has been torn up in compression runs (some $82 trillion to date) or has been cleared. Compression in the IRS market has totaled a staggering $164 trillion through year-end 2011.[9] Dealers are getting much better at compression of both IRS and CDS products and more progress is coming.[10]

Through ISDA, trade repositories are in place for credit and rates products, and commodities and equity derivatives are in the works. ISDA has also proposed building a counterparty credit repository that will contain the value of each counterparty's derivatives as well as the collateral that supports it.

There has been much talk about the riskiness of the CDS market, and I thought it would be useful to go through the metrics and risk practices of the product. First, market data has been available through the Depository Trust & Clearing Corporation ("DTCC") and its website.[11] As of year-end 2011, DTCC reported some $25.9 trillion of notional outstanding CDS,[12] with non-dealers making up $4.5 trillion. Actual open positions total only $2.7 trillion.[13] The other important point to understand with respect to CDS is the very high level of collateralization. ISDA's last margin survey indicated large dealers

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8. *See OTC Derivatives Supervisors Group,* FEDERAL RESERVE BANK OF NEW YORK, http://www.newyorkfed.org/markets/otc_derivatives_supervisors_group.html.

9. *Interest Rate Swap Compression: A Progress Report,* ISDA, 1 (Feb. 2012), http://www2.isda.org/functional-areas/research/studies/.

10. *See id.* at 9 (discussing the progress dealers have made in IRS compression and CDS progress).

11. THE DEPOSITORY TRUST & CLEARING CORPORATION (Jan. 24, 2013), http://www.dtcc.com/.

12. *See OTC Derivatives Market Analysis: Year-end 2011*, ISDA.ORG, 7 (June 2012), https://www2.isda.org/attachment/NDQzNQ==/Market%20Analysis%20060612.pdf.

13. *Id.*

required over 95% of their counterparties to post collateral. Clearing results from the BIS show $5.5 trillion of cleared CDS but this does not include the compression I noted a few moments ago of $82 trillion. The most recent figures for net open positions on Greece showed total exposures of just over $3 billion.

V. OVERKILL?

As I get into my final topic, I'll remind the audience once again that I am speaking as a private citizen. I'll also remind the audience I believe in what I say.

First, let's look at clearing. It looks like a panacea, but is it? Clearing breaks down netting sets and displaces exposures. Now, a client dealer relationship will net IRS against CDS, equity derivatives, and commodity derivatives. It is possible to net an entire derivative relationship. What might happen with clearing? In individual asset classes, some positions will be cleared and subject to margin requirements. In the same asset class, other positions will be executed bilaterally and will require margin as well. Many products that can be cleared are actually executed because they are hedges for products not eligible for clearing such as swaptions. In this way, clearing may double up the need for collateral. This problem is multiplied because there will be separate clearing houses for each product. Furthermore, the number of clearinghouses per asset class is forecast to be large, as many countries will require transactions in their markets to be cleared in a local clearinghouse.

Cleared and non-cleared trades will also be subject to initial margin requirements.[14] This is a troubling requirement as estimates of initial margin run in the trillions. If we assume the cost of the margin is 1%, this amounts to $10 billion per trillion per year. Does anyone believe that this is the right price to pay for this protection? We are not talking about variation margin. How much could have possibly been saved with initial margin? I think the amount is probably in the tens of millions globally per annum. Can not a clearinghouse or other entity provide the same protection more efficiently? I suggested several months ago that variation margin is the critical collateral required for safety. Suppose each dealer were to use an entity licensed by regulators to collect

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14. *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732 (proposed Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23).

variation margin collateral across all derivative products on a netted basis. We would retain the benefits of netting and capture the main benefits of clearing. The same licensed entity could organize the liquidation of dealer portfolios in a dealer bankruptcy, perhaps by collecting some margin from the dealer. Surely, the savings to the system would amount to hundreds of billions, if not trillions, of dollars of margin.

I have not mentioned the systemic risk that might arise out of clearinghouses and I cannot blame regulators entirely for forcing an old-fashioned remedy on the derivatives market. It is up to the industry to design a better mousetrap. It will be up to regulators to analyze the mousetrap to ensure it is strong and flexible. We do not have to eliminate losses on derivatives, but rather ensure any losses are modest.

My second example of overkill is the mandate for executing certain transactions on electronic platforms called swap execution facilities. This, of course, is not designed to reduce systemic risk in the marketplace. It is a change of structure that demands a cost-benefit analysis that can justify the mandate. Such an analysis has not been done by any government agency. We performed such an analysis at ISDA for the IRS market. We found that participants expected to get worse pricing as a result of the mandate, and the infrastructure cost in the US alone would be in excess of $200 million per year with much larger upfront costs. We also showed there would be meaningless benefits at best to small users. Policymakers are jamming the futures industry infrastructure on entirely different markets. In my judgment, this provision is not needed at all and I welcome any member of the audience to justify its existence.

I will make one other observation about reform: It is needed, but it needs to be done carefully and analytically. We have not seen this. As I said, many parties were to blame for the financial crisis. Regulation enabled banks to set aside no capital for many sovereigns and to lever $1 of common equity over 700 times through investments in CDOs. They need to listen as well as prescribe regulations.

I would like to end my remarks with a story. It is a story about Justice Oliver Wendell Holmes. It seems the famed jurist was getting on in years, and one day was taking a train trip. The conductor approached him to ask for his ticket and Holmes fumbled around looking for it. The conductor recognized Holmes and smiled at him saying, "Don't worry Justice Holmes. You can mail the ticket in when you find it." To which Holmes replied, "The problem isn't where is my ticket? The problem is where am I going?"

I think in the rush to enact—and to implement—regulatory reform, we can forget exactly what it is we are trying to do. We focus instead on the politically expedient, or the little, and not the big picture. That, of course, is a big mistake and we need to work hard to prevent it.

This concludes my remarks. I hope I have given the panelists food for thought.