

outlook



The Importance of Certainty

By Andrea Corcoran

The credit crisis of 2008, which will go down in history as the most severe since the Great Depression, undoubtedly will bring about a profound reassessment of how financial markets and financial institutions are regulated and supervised both here and abroad. While it may take years for this debate to play out, it is already clear that managing systemic risk will be one central area of focus, given the extraordinary scale of the government interventions to maintain functioning financial markets, to deter bank runs, to unlock frozen credit, and to rescue major financial institutions in the U.S. and Europe.

I say managing, not limiting, because systemic risk in some respects is now even greater and more complex than before. The extraordinary consolidation that has transformed Wall Street in just a matter of months has greatly magnified the “too big to fail” problem that banking regulators have wrestled with for decades. And the rescues of American International Group and Bear Stearns—combined with the ongoing repercussions of Lehman’s bankruptcy—show us that this problem is not just a matter of size, it is also a matter of knowing who is connected to whom and how.

This article focuses on only one dimension, namely the lack of certainty. By this I am referring not only to the difficulty of obtaining certainty in the valuations of financial assets such as mortgage-linked securities and securities tranches, though that is certainly a central factor. I am also referring to certainty as to the creditworthiness of financial institutions, certainty as to counterparty exposures, certainty even as to one's own financial exposures, and certainty as to the likely public response to credit gridlock and commercial failures. These various forms of certainty are all essential to maintaining market confidence, and market confidence, as we have seen, is essential to the functioning of the financial system.

Here is where the exchange-traded derivatives world has a signal contribution to make. The futures industry does provide a proven credit enhancement model intended to increase certainty to market participants, to limit contagion and to price risk in a transparent way. As the debate over regulatory reform moves forward next year and beyond, policymakers would be well advised to consider the essential elements of this model in their search for solutions.

But the futures industry's track record is not perfect by any means. In fact, the current crisis has exposed several areas where improvements should be made. This is particularly true in the procedures for dealing with insolvencies of international and cross-sectoral scope. As shown in the case of Lehman Brothers bankruptcy, where customer assets were frozen by the bankruptcy administrators for an extended period of time, it is essential for both customers and intermediaries to know the applicable rules and procedures in every relevant jurisdiction and for public policy to favor the markets as a whole, not just *saue qui peut*. In addition,

the Lehman case demonstrates the potential value of ensuring that when an intermediary declares bankruptcy, there are well-established practices for the immediate transfer of all client assets out of that firm, including both outstanding positions and funds deposited as collateral.

The Search for Certainty

The current crisis has concentrated the minds of panic-stricken economists, politicians and regulators alike on the value of certainty. Certainty is the very heart of our lender of last resort system for banks and other financial institutions. These, as we know but sometimes forget, borrow short and lend long and in consequence require the forbearance of creditors to survive. Forbearance is based on belief in the integrity and stability of the system—in a word, belief in certainty.

Uncertainty is agreed by most pundits to have exacerbated the current liquidity crisis on both sides of the Atlantic and the failures and losses it precipitated. This uncertainty takes many forms: the proliferation of opaque asset classes, the unknown degree of interconnectedness among markets and firms, the inconsistent approaches to similarly situated institutions, the inability to coordinate rescues or mitigating processes promptly across borders, and the paralysis or transmission of a fraught sense of emergency of policymakers.

These are areas where the futures markets have some learning to share. These markets have functioned well even in the current extremes, contributing to confidence in at least one sector of the financial system. There is also much to gain from a broader adoption of the industry's continuing drive to obtain global consensus on default procedures and customer funds protections.

The Futures Model

In our parochial world of domestic futures markets, transparency of risk is king. It is a truth universally acknowledged that losses and gains must be settled daily, or more frequently, to prevent the accumulation of unsecured exposures and the consequent threat to market integrity. It is also regarded as sacrosanct that large exposures must be aggregated across all the intermediaries through which they are held. The aggregate exposures must be transparent to the facility that provides credit enhancement, the exchange on which the positions are taken, and the government.

Certainty is also supported by the protection provided for customer funds in case of a default by the intermediary holding those funds. Central to these markets is the understanding that money, securities and property deposited by customers through an intermediary should not fall claim to creditors of the intermediary or its custodians or advisors, but instead it should be dedicated to the margin and settlement of futures transactions on behalf of such customers.

In contrast to other financial markets that have contributed to the credit crisis, and in some cases have nearly stopped functioning, the futures model is intentionally designed to promote certainty, preserve confidence, and limit contagion. Rather than relying on individual analysis of credit exposures, the futures model is based on a credit enhancement and risk management framework that greatly reduces counterparty credit risk. It creates an environment where trading is anonymous and risk positions that counterparties do not wish to expose directly to each other are transparent to the clearing facility.

The futures model renders transparent not only the net risk, but also the gross position risk within markets. It moderates credit

risk engendered by accrual of market risk. It facilitates the early identification of financially compromised intermediaries, and customers or brokers who are on the wrong side of a market move, including risks posed by participants operating through multiple intermediaries. It provides real prices for real financial transactions.

This framework also limits the transmission of risk by: (1) quarantining sick firms through moving funds and positions on behalf of healthy customers to healthy intermediaries, (2) preserving the potential to liquidate cash and derivatives positions that hedge each other in tandem to prevent expanding unsecured risk, and (3) assuring the free use of clearing margins previously paid to maintain losing positions for the purpose of making payments on winning positions. It binds specific resources at a financially compromised firm and at the relevant clearing and credit enhancement facilities to support these objectives, and it offers incentives for the appropriate handling of customer accounts.

The U.S. futures industry and the Commodity Futures Trading Commission have advocated effectively the strength of this system globally and most mature futures markets use a very similar framework of support for their listed derivatives activities. Global awareness of the benefits of these protections is reflected in the FIA Financial Integrity Protections, the Windsor Accord, and the companion regulatory and industry versions of the Boca Declaration, which is now almost two decades old and has 70 signatories.

More recently, the value of futures-style credit enhancement was recognized by the Committee on Payments and Settlement Systems and the International Organization of Securities Commissions through their joint recommendations for central counterparty systems issued in 2004.

Transfers of Customer Assets

Despite these protections, there have been a number of instances when certainty has been tested by the failure of a major participant in the futures markets. What is critical, nonetheless, is that even in cases where there was protracted litigation, the firm's domestic market was able to immediately transfer positions to another firm in better financial condition. Futures are wasting assets, and the ability to move healthy customers' positions to a healthy firm as fast as possible is largely acknowledged as vital to

the avoidance of adverse knock-on effects.

This was true in the case of Barings, where the then-solo Liffe transferred positions before announcing the rogue trading problems in Singapore, the CME did so immediately thereafter, and most Asian markets attempted to provide similar relief. This was true in the case of Griffin, where the Chicago Board of Trade acted immediately to move all regulated customer listed positions and where Eurex was able to apply clearing margin immediately to clear the market. This was true in Metallgesellschaft where clearing risk was able to be dispersed among multiple clearing firms and where the parent company honored its guarantee to pay losses on trades while positions remained open. This was true in the case of Refco, where while many disputes revolved around Refco Capital's unregulated business, the regulated FCM was able to move customer positions to new homes expeditiously and without loss. And this was true even in the egregious cases of Catalfo, Zimmerman and Klein, where the fact of the criminal consequences of taking excessive positions that compromised customer funds, together with exchange rules on proper behavior, "encouraged" principals to use their own money to restore funds to customers to prevent further risk to the system.

This basic framework remains in place today and continues to provide incentives to market participants to resolve market events and to give the market some comfort as to expected results. For example, in September, Lehman Brothers, Inc.—the U.S. regulated entity of Lehman—was able to move more than 135,000 customer accounts. The close-out of over-the-counter positions also was permitted and protocols were established for recovery of funds claimed subject to indemnification of the liquidators against mistakes.

On the other hand, the Lehman transfers were not completed without any bumps in the road. While customer positions at Lehman Brothers Inc. were transferred successfully, it took more than a week for the collateral associated with those positions to be moved out of Lehman's accounts at the custodial bank. Such a delay causes angst to the customer and potentially puts the integrity of the clearing system in stress. This liquidity is particularly true in an environment where liquidity is so critical and market maker prices are so volatile. That being said, there was broad consensus that the transfer should happen, there was legal support for

the process in the Bankruptcy Code and in the CFTC's regulations. There was general acceptance of the types of interventions necessary and the escalation of measures available to stem contagion in advance. Consider the obverse, where there is no agreed-upon framework for taking prompt corrective action by moving customer accounts or other measures, and where the solutions require ad-hoc interventions by government authorities that, while necessary, may themselves inject uncertainty.

Many things have changed since Congress last looked intensely at the composite of financial integrity protections that support futures trading. In the case of Lehman, while customers' positions were moved expeditiously to solvent clearers, the bankruptcy administrators did not always permit the movement of customer funds. Moreover, because of policies favoring ring-fencing, and issues related to who held what in the over-the-counter markets, the U.K. entity's liquidators recently indicated that it could take months to resolve who owed what to whom in many cases.

The Lehman bankruptcy also revealed a relatively new exposure to contagion in the management of collateral. One of the money market funds used by intermediaries as a means to invest margin posted with the CME "broke the buck" in September, due partly to its exposure to Lehman corporate debt. To protect itself, the fund halted withdrawals, preventing intermediaries from accessing the margin monies and causing the CFTC to order intermediaries to write down the value of their holdings. This created financial pressure on firms through the operation of the market, not through their own actions.

A Place at the Table

Much of the blame for the crisis, rightly or wrongly, has fallen on OTC derivatives markets, and these are likely to be a major area of attention in the coming debate over how to improve the regulatory system and in the competition to provide a market-based solution. The futures markets, on the other hand, have come through the crisis, thus far, more or less intact, and as a result they may be overlooked in future policy discussions.

This would be a mistake. Not only does the futures model provide important insights for improving how we manage systemic risk, it is also too large and too interconnected

with the rest of finance to ignore. Equally important, the futures model itself is in need of a rethink, given the dramatic growth and evolution of the futures business over the last several years.

In 1974, when the CFTC was formed, the average amount of segregated funds held on behalf of customers was \$0.2 million. In 1984, that amount had risen to \$8.7 million. Today, the amount of customer money held in the U.S. futures industry is exponentially larger. As of July 31, the total amount of segregated funds was \$157 billion for all firms combined. Twenty six firms held more than \$1 billion in segregated funds and more than seven held double digit billions. Additionally, more than \$48 billion was required to be secured on behalf of non U.S. accounts held for U.S. customers.

Going beyond the numbers, the business of futures and futures clearing has become vastly more complex. Funds are now kept in multiple major market currencies besides dollars. The investment of customer funds is no longer restricted to instruments backed by the full faith and credit of the U.S. government. Multiple cross margining programs between futures and securities accounts exist and expanded portfolio margining is being designed. Intermediaries participate on multiple listed derivatives exchanges around the world, and may have parent firms regulated by multiple government entities in multiple jurisdictions with vastly different insolvency laws. And technology has accelerated the speed at which markets reflect information and hence has increased the risk of overshooting up or down.

Therefore, while it may be that the system we have continues to be serviceable, careful analysis in the context of today's situation is definitely warranted and should be coordinated with the other thinking going on to be certain that it remains robust. In particular, industry leaders and government policymakers should consider the following recommendations:

- Know the applicable rules and procedures in every relevant jurisdiction. Develop a data base of the provisions (exchange rules, regulatory rules, and insolvency provisions) for managing defaults and treatment of customer funds and custodians of such funds in all the countries now doing listed futures business and identify in advance who would need to work with whom to resolve a cross-border insolvency. [This would be an expansion of the type of work

originally to be concluded as part of the Trans-Atlantic Dialogue with CESR, but should be expanded to include other market centers outside of Europe and the U.S.—Singapore, Hong Kong, Japan, Brazil—with significant business and large intermediaries.)

- Increase common practices that support the transfer of full accounts. Revisit the handling of insolvencies that affect the financial markets and determine whether it is possible, domestically and internationally, to further reinforce and harmonize mechanisms to prevent contagion. In particular, to assure the transfer in full of accounts, both money and positions. If such full transfers do not take place then, to permit the release of funds to their owners that are for margining transferred positions and that are subject to hold backs or indemnification of final pro rata share accounting.
- Obtain more timely and more realistic OTC exposure information to permit better management of emergency situations by providing prompt access to an improved view of the full position of potentially exposed intermediaries and end users. In other words, get serious about what information about over-the-counter exposures needs to be transparent, when and to whom.
- Assure that all systemically important institutions, including derivatives clearinghouses, have access to the Federal Reserve's liquidity facilities.
- Consider whether the time has come for a well-designed insurance program to facilitate the transfer of full accounts or the flow of settlement funds in situations where uncertainties freeze up credit. Consider whether insurance should apply to all financial products and institutions, rather than just retail structures, and to what extent such arrangements should be integrated. In particular, reconsider whether insurance should buttress segregation, and whether it is possible to institute risk-premia based insurance programs to insure any shortfall caused by market events that exceed a particular level of price change.
- Revisit how best to share market information and deploy rescue activities on both a national and cross-border basis. Consider how best to use the ability of local regulators and specialist expertise to contain specific risks within a system that seeks to move toward more formally coordinating

and synchronizing national approaches.

- Tweak the mark-to-market process. Undertake an economic analysis of whether an automatic, pre-established symmetric fire sale or bubble circuit breaker could be applied to OTC markets as well as exchange products, to allow the OTC as well as the exchange market time to adjust to events, to permit equilibrating demand to emerge, and to prevent destabilizing overshooting.

The CFTC and the futures industry have implemented substantial financial integrity protections and secured buy-in to the framework of these protections around the world. They have operated, and risk managed, and overseen a system that never had a separation between banks and "investment" activities. They have operated in a market which is highly global and have managed through various formal and informal information sharing arrangements and networks a number of crises, including not only the market disruptions of 1987, 1989 and 1997 but also the physical destruction of several important futures markets on 9/11.

The CFTC has daily information on the aggregated market exposures of traders across US regulated markets and the power to obtain cash market, including OTC derivatives, information relative to those positions. It also knows where billions of customer funds are located. As such, it should be a full partner at the table in the coming dialogues. And before we rush, as media reports have suggested, to give up our system, which has brought so much prosperity and innovation and upward mobility to our large and diverse country, let us carefully examine what is fundamental to well-functioning capital and risk shifting markets. In so doing, we should develop a sustaining infrastructure that addresses excesses, reduces bad incentives, and renders risk management more robust. ■

Andrea Corcoran is principal, Align International LLC, a regulatory consultancy. She previously held several senior positions at the Commodity Futures Trading Commission, including head of the agency's international affairs office.