Comments on
Professor Craig Pirrong Paper
A Bill of Goods: CCPs and Systemic Risk

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Unique Contribution
• Understands Industry
  — Market Practice & Products
  — Motivations of Participants
• Understands Academic Literature
• Understands Historical Continuum
• Benefit of Paper – can’t analyze “clearing” in a Vacuum

GFC Liquidity Crisis
Fed Intervention
• Fed Term Auction Facility - $493 Bill (3/09)
• Term Securities Lending Facility - $234 Bill (10/08)
• Primary Dealer Credit - $147 Bill (10/08)
• Money Market Facility - $145 Bill (1/09)
• Commercial paper Facility - $349 Bill (1/09)
• (Fed Balance Sheet)
• Periods of no LIBOR lending during GFC
Challenges

Traditional Beliefs on Justification for Clearing

• More CCP Netting = Reduced Risk
• Margining reduces systemic risk
• Clearing reduces interconnectedness
• Key Question: Are we fixing (or adding to) systemic risk by mandating the clearing of OTC derivatives?
  – Other issues that impede progress?

Clearing Advantages

• Clearing Reduces Systemic Risk (paper issues)
• Clearing Creates Transparency
  – More information than bilateral market
    • Pricing and volume
    • Bids and offers in real time
  – Regulation is more effective with transparency
    – Increased Liquidity = easier unwinds
• Cleared trading is easier to regulate
• Will transparency itself reduce systemic risk?

Bilateral Trading Conundrum

• Problem: many of Pirrong’s concerns stem from initial margin requirements and rigorous margining
• Do we have the same problems with “fully margined” uncleared trades?
“Run Prone” Capital Structure Problem

- Argument: Clearing will create market stress which may trigger runs
- Query: do we fix "clearing" or do we fix/regulate capital structures?
- Repo Runs
  - Poor risk management by Dealers
  - Dealers could do longer term repos but more expensive
  - Gambling with short tri-party repo debt
- Money Market runs
  - Poor risk management by Fund managers
  - Asset/liability mismatch
  - “Breaking Buck” Problem - Triggered by Lehman Failure

Interconnectedness

- Argument: “indirect” and direct interconnectedness will still exist after clearing
- Query: Is Interconnectedness a “bigness” problem or a clearing problem
- Clearing – chance to minimize connectedness
- Should focus be on “bigness” regulation?

“Collateralization Redistributes Risk, Rather than Eliminating it”

- Collateral decision: generally a creditor/borrower negotiation
- When does government require collateral between private parties?
- Political Choice: mandated clearing (margining) for derivatives
  - Systemic reasons for this choice?
- Problems: lenders are engaging in risky lending – not really a clearing problem
Are “Cleared” OTC Derivatives the Issue?
• Is this unique from futures?
• Do we have the same issue for futures?
  — Are critiques unique to clearing OTC derivatives?
• Is additional volume the problem?
• How do they differ from futures that would create systemic risk problems?

Question: What do we Do?
• “Forewarned is Forearmed”
• Mandatory Cleared Products – limited
  – Interest Rate Products
  – Certain Index CDS Products
• “Uncleared” Products Question? – still have same issue with margining
• Lesson for other G20 jurisdictions?