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?