FACULTY OF LAW
UNIVERSITY OF OXFORD

Hardwired Conflicts:
The Big Bang Protocol, Libor and the Paradox of Private Ordering

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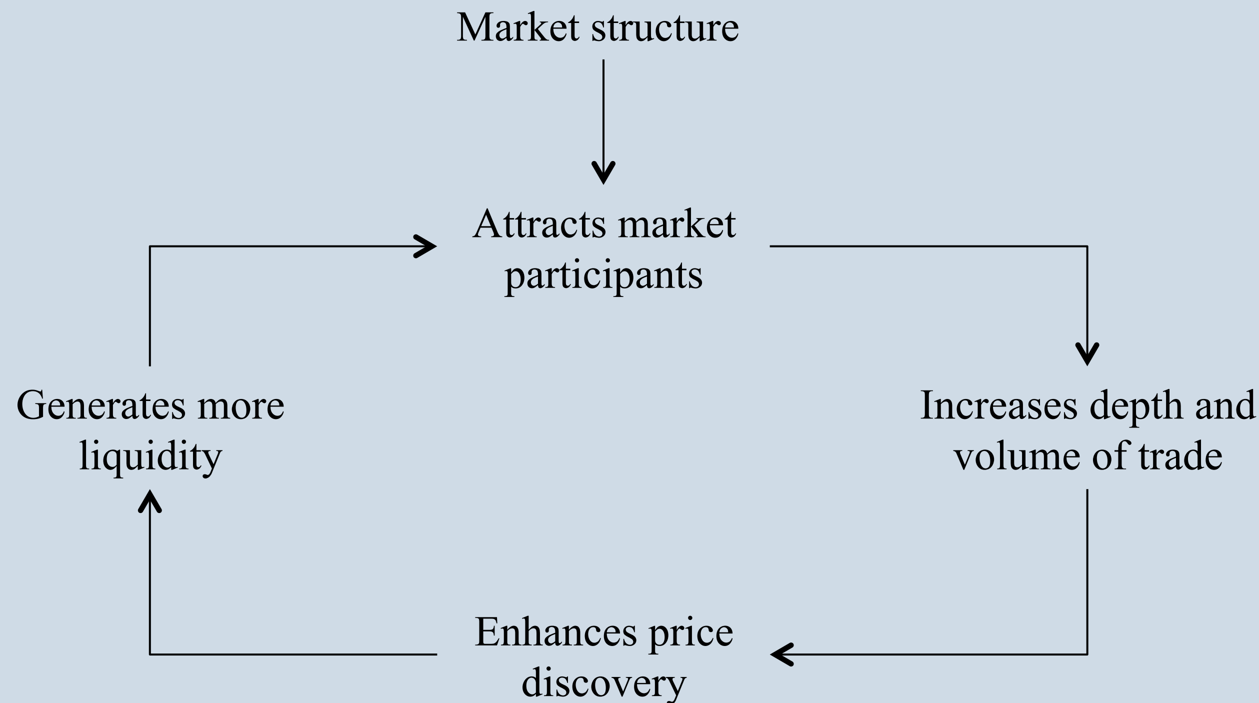
The Starting Point

- We tend to view market participants as possessing high powered incentives to develop market structures – e.g. contracts, private rules and other governance arrangements – which generate *credible commitments*.
  - Fischel and Grossman (1984).
  - Greif (1993).
  - Milgrom, North and Weingast (1995).
  - Mahoney (1997).
  - Macey and O'Hara (1999).
  - O'Hara et. al. (2003).

The Starting Point

- In this way, market structure can be understood as an important source of Pareto improving *gains from trade*.



However …

- Almost by definition, successful market structures generate *positive network externalities*.
  - Increasing barriers to entry.
  - Insulating incumbents from vigorous competition.
  - Undermining the emergence of welfare enhancing innovation.
- They may also be *captured* by market participants.
- Thus generating significant coordination, agency and other costs.
  - And, seemingly, leaving further Pareto improvements on the table.
- This is the *paradox of private ordering*.

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Project Overview

- This project explores the paradox of private ordering through the lens of an inductive case study.
  - ISDA and, specifically, its 2009 'Big Bang' Protocol.*

- And by drawing parallels between the Big Bang Protocol and another key structural feature of OTC derivatives markets.
  - BBA Libor.

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ISDA

- The driving force behind the development of market structures within bilateral swap markets.

- Specifically, ISDA has played a key role in developing:
  - Standardized ‘master’ agreements and supporting documentation for interest rate, f/x, commodity, equity and credit derivatives.
  - Protocols which facilitate the *ex post* amendment of existing master agreements.
  - Model legislation governing closeout netting and financial collateral arrangements (adopted in 40+ jurisdictions).
  - Financial Products Mark-up Language (FpML).

ISDA

- The benefits of these market structures can be understood as flowing largely from *standardization*.

Standardized legal terms (*k.*)

Standardized netting legislation
(in each of A, B and C)

Standardized back-office processing
(FpML)

Inter-temporal standardization via
protocols

ISDA

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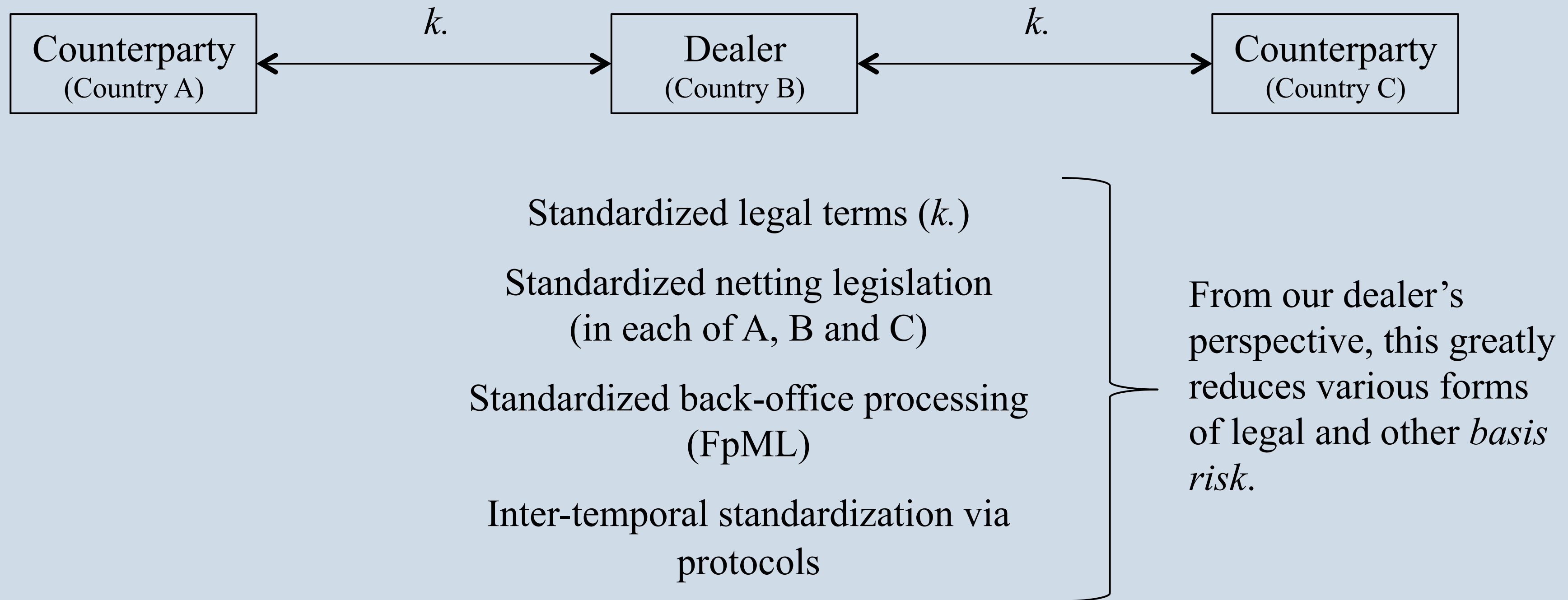

The Big Bang Protocol

- Designed to facilitate cash settlement of CDS.
  - Following on from problems with physical settlement (e.g. Delphi).
  - And successful *ad hoc* experiments (e.g. Dura).
- Effectively a response to two problems:
  - The need to establish a process for determining a market price for the underlying as a precondition to cash settlement.
  - The need for *someone* to make important decisions about when and how the process should be run.*

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The Big Bang Protocol

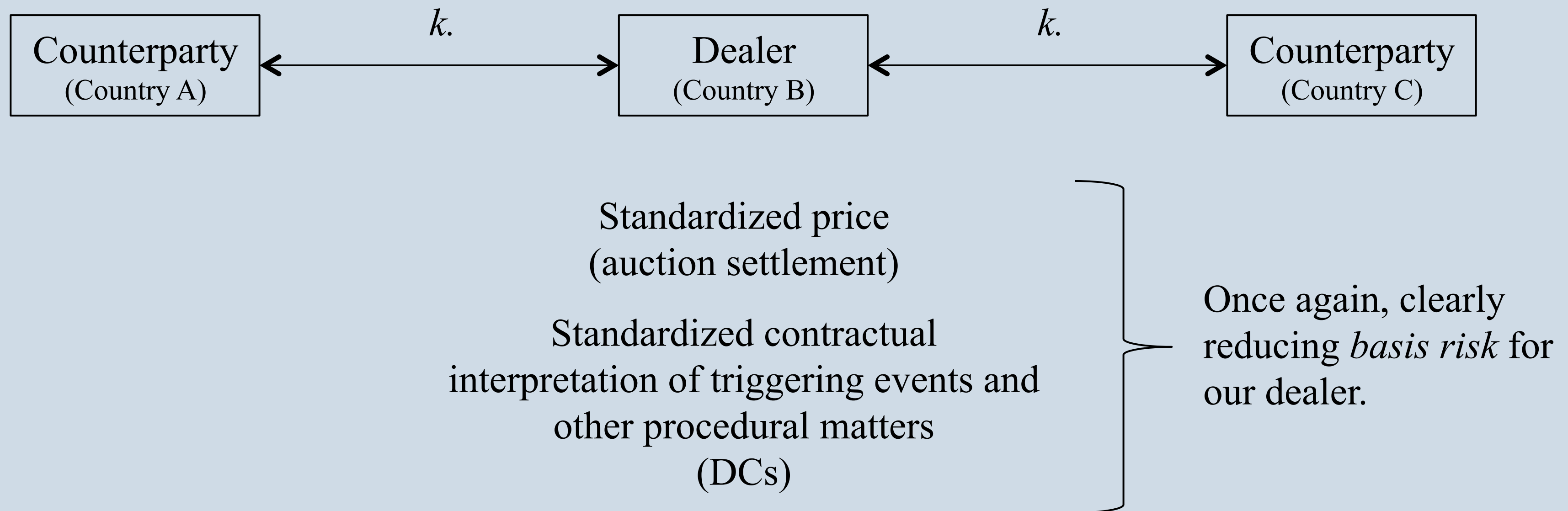
- Hence, the twin market structures of *auction settlement* and *determinations committees* (DCs).

Standardized price
(auction settlement)

Standardized contractual
interpretation of triggering events and
other procedural matters
(DCs)

The Big Bang Protocol

- Hence, the twin market structures of *auction settlement* and *determinations committees* (DCs).



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Determinations Committees

- Under the DC rules, DCs have been delegated responsibility for making a number of important determinations.
  - Whether a triggering credit, restructuring or succession event has occurred.
  - Whether to hold an auction to establish a price.
  - The identity of reference obligations to be priced in the auction.
- Importantly, a DC's determinations are binding in respect of *all* CDS contracts of the relevant type which incorporate the protocol.

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Determinations Committees

- Each DC is composed of 15 voting members.
  - 8 global dealers.
  - 2 regional dealers.
  - 5 non-dealer ('buy-side') counterparties.

- Most important decisions must be made by an 80% supermajority.
  - And where this threshold is not reached, the DC rules contemplate that the issue will be referred to a panel of external reviewers.
  - Interestingly, external reviewers are subject to conflict of interest rules, but DC members are not.

Determinations Committees

- DC members are required to make determinations in a commercially reasonable manner, based on publicly available information.

- Simultaneously, however:
  - DC members enjoy a disclaimer of liability.
  - They are not subject to conflict of interest rules (e.g. removal or recusal mechanisms).
  - They are not required to establish internal governance mechanisms to manage potential conflicts of interest.
  - DC rules are a contract between ISDA and DC members, not counterparties.
  - ISDA does not engage in active monitoring of compliance with DC rules.

The Paradox

- The DC mechanism holds out a number of potentially significant benefits for market participants.
  - e.g. the avoidance of costly, duplicative and potentially inconsistent third party dispute resolution; more efficient central clearing.
- Simultaneously, however, DC members are permitted to wear two hats.
  - One as major contractual counterparty.
  - The other as an adjudicator of issues which determine the payoffs under contracts to which they are themselves counterparties.
- This gives rise to hardwired conflicts of interests (agency costs).
  - And, in the absence of effective internal or external constraints, renders this market structure susceptible to abuse.

The Paradox

- A reasonable person might raise two objections at this point.
  - First, where is the empirical evidence to support the hypothesis that this market structure is susceptible to abuse?
  - Second, if these agency costs were significant enough, wouldn't market forces have resulted in Pareto improving innovations?
- It is at this point that drawing parallels between the DC mechanism and BBA Libor can enhance our understanding of the problem.
  - Where we now *know* abuse has occurred.
  - And where, despite longstanding concerns of a similar nature, market forces failed to produce 'Libor 2.0'.

The Paradox

So let's take a closer look at some of these parallels…

The Key Players

The G14	Libor Panel Bank	DC Member (Americas)
Bank of America	✓	✓
Barclays	✓	✓
BNP Paribas	✓	✓
Citigroup	✓	✓
Credit Suisse	✓	✓
Deutsche Bank	✓	✓
Goldman Sachs		✓
HSBC	✓	✓
JPMorgan Chase	✓	✓
Morgan Stanley		✓
Royal Bank of Scotland	✓	
Société Générale	✓	✓ (consultative)
UBS	✓	✓
Wells Fargo		

The Nature of the Conflict

- Both Libor and the DC mechanism are structured around a ‘core’ group of market participants.
  - e.g. Libor panel banks and DC members.

- In both cases, the distinguishing characteristic of this core is that, by virtue of these market structures, its members have a say in determining issues which determine payoffs under contracts to which they are themselves counterparties.

- By implication, this also creates a ‘periphery’ who are vulnerable to abuse by the core.

The Nature of the Conflict

Ultimately, of course, we might view this as largely unproblematic so long as effective *internal* governance mechanisms are built into these market structures…

Weak Internal Governance

- Both Libor and the DC mechanism are the products of industry trade associations and their members.
  - e.g. the BBA and ISDA.
- Which arguably possess relatively weak incentives to monitor market conduct.
  - As evidenced by the fact that neither has devoted meaningful resources toward active monitoring of these market structures.
  - And the apparent lack of a credible internal enforcement threat.
  - Indeed, the BBA failed to undertake meaningful monitoring even after the *Wall Street Journal* handed them evidence suggestive of rate fiddling.

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Weak Internal Governance

Okay, no worries. The threat of *external* – i.e. market-based – governance mechanisms will still constrain opportunistic behaviour.

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Weak External Governance

- With respect to both Libor and the DC mechanism, the credible threat of market-based sanctions is undermined by the existence of pronounced network externalities.
  - Generating an acute coordination problem, and multiple equilibriums.
  - Note that these externalities are a natural by-product of these structures' most important benefit: *standardization*.

- In the case of the DC mechanism, the high coordination (switching) costs associated with these externalities are compounded by the *bundling* of ISDA's products (e.g. master agreements, access to auction settlement, and the DC mechanism).

- And the fact that dealers effectively *anchor* the market to the existing structure.

Weak External Governance

"If history is any guide, the dealer community will likely require that counterparties incorporate the terms of the [Big Bang Protocol] into every confirmation for future transactions. Meaning that, at least on a going-forward basis, parties wishing to transact in the CDS market will have to live with ISDA's CDS changes."

- Ropes & Gray LLP (March 4, 2009).

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Weak External Governance

- The credible threat of market-based sanctions is also undermined by acute *information problems*.
  - Very little verifiable information in the marketplace.
  - Decisions involve the exercise of discretion.
  - Information susceptible to multiple interpretations.
  - Absent poor judgment and bravado, abuse is relatively easy to conceal.
- Importantly, this undermines not only the threat of market-based sanctions, but also scrutiny by public regulatory authorities.
- Beware the fallacy of *rara avis in terris nigroque simillima cygno*.

The Parallels in Summary

	BBA Libor	ISDA DCs
The Key Players	Dealer banks	Dealer banks
The Nature of the Conflict	Adjudication of issues which determine payoffs under *k.* to which they are a party	Adjudication of issues which determine payoffs under *k.* to which they are a party
Weak Internal Governance	Yes	Yes
By industry trade association	BBA	ISDA
Active monitoring	No	No
Weak External Governance	Yes	Yes
Positive network externalities	Yes	Yes
Information problems	Yes	Yes
Bundling	Maybe	Yes
Anchoring	Maybe	Yes
ABUSE	**YES**	**???**

Resolving the Paradox

- Disclosure?
- Conflict of interest rules for DC members?
- Trading restrictions?

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Resolving the Paradox

- Disclosure?
  - Relies on credible enforcement threat.
  - Plagued by information problems.
- Conflict of interest rules for DC members?
  - Already exists for independent review panels.
  - Still plagued by information, enforcement problems.
- Trading restrictions?
  - Would suffocate dealer-intermediated markets.
  - Potential stability implications.

Resolving the Paradox

- A fourth option: delegation to independent third parties.
- As it happens, DC rules already contemplate just such a class of independent adjudicators: expert review panels.
  - And they already come with their own set of conflict rules!
- The key question, then, becomes whether the resulting reduction in agency costs would be outweighed by any loss of expertise.
  - Which is why few seriously think replacing Libor panel banks with a public rate-setting authority is a good idea.
  - With respect to the DC mechanism, however, it is not readily apparent that DC members possess an inherent comparative advantage.

For further reading:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2262712