

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

Conrad P. Voldstad  
Chief Executive Officer

International Swaps and Derivatives Association, Inc. (ISDA)

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# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

Time frame is two to three years in the future

1. Moderate Clearing
2. More Severe Clearing
3. U.S. Banks Derivatives Activities Pushed Out
4. Unresolved Risk Issues
5. Conclusion

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

## Moderate Clearing

- a) Vast majority of all derivative products will be clearable
- b) Exemption for end users and smaller financial institutions
- c) Number of clearinghouses but one dominant CCP per asset class
- d) Standardized, cleared products executed on exchanges or SEFs

## SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

- a) Vast majority of all derivative products will be clearable
- Interest rates: IRS of most types, option products, FRAs, basis swaps, cross currency swaps, municipal swaps
  - CDS: most indices, tranches of indices and single name CDS
  - Equity and commodity derivatives: standardized products

## SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

### b) Exemption for end users and smaller financial institutions

- Option to use clearinghouses
- Segregation of collateral if applicable
- End user losses in Lehman very modest

## SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

- c) Number of clearinghouses but one dominant CCP per asset class
- Conditions of membership for large CCPs onerous
  - Smaller CCPs may have less onerous membership or client collateral requirements
  - Large investment firms will be clients of members
  - Portability of positions and segregation of collateral
  - Systemic risks in clearinghouses

## SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

- d) Standardized, cleared products executed on exchanges or SEFs
- Interest rate products: no broken dates, no off-market structures
  - CDS: no bespoke transactions
  - Equities and commodities: no broken dates, no unusual indices, price sources
  - Numerous SEFs: IDBs, TradeWeb, Bloomberg, Reuters, exchanges
  - Block trade exemption
  - EFFECT ON LIQUIDITY?

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

## More Severe Clearing

- a) Exemptions for clearing apply only to official bodies  
greatly reduced hedging from end users
- b) All cleared products to go through exchanges or SEFs  
greatly reduced liquidity in most derivative contracts

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

## U.S. Bank Derivatives Activities Pushed Out

- a) Moderate clearing: beneficial to international banks
- a) Severe clearing: little competitive impact unless...

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

## Unresolved Risk Issues

- a) Financial casualties all caused by real estate exposure
  - AIG
  - GSEs
  - Large commercial banks
  - Large investment banks
  - Second "biters"
  - Mortgage and regional banks
  - Monoline credit insurers
- b) Poor underwriting/lending
- c) Horrific risk management
- d) Not addressed in financial reform
- e) Derivatives complex products - synthetic CDOs not explicitly managed in financial reform. Cannot clear now, or ever?

# SCENARIOS FOR THE U.S. DERIVATIVES MARKETPLACE

## CONCLUSION

- a) Expansion of clearing will reduce systemic risk but may create systemic risk in clearinghouses
- b) Exchange trading will increase transparency but may reduce liquidity
- c) Rules need to balance systemic risk considerations and transparency with cost of hedging and liquidity of markets