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Abstract

The question raises firstly the issue of the definition of systemic risks. Although there have been several definitions proposed, it is widely accepted that it is a flexible notion, difficult to capture in one sentence, and changing depending on time and context. Also systemic features cannot be analyzed only from the side of the individual financial institutions, or even of a group of parent and subsidiaries. Finally one has systemic events: the suspension of redemptions in two investment funds lead to systemic concerns in early august 2008.

So what is systemic is extremely difficult to define ex ante, and it is probably better that we do not define it too clearly: "constructive ambiguity", that great invention of central bankers, is the appropriate approach here too.

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What systemic risks may concern specific players/activities such as derivatives, CCPs and Hedge Funds? How to mitigate them?"

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The question raises firstly the issue of the definition of systemic risks. Although there have been several definitions proposed, it is widely accepted that it is a flexible notion, difficult to capture in one sentence, and changing depending on time and context. Size as such is not a criterion, as we have seen in 2008-2009, when several banks defaulted and triggered the governments' intervention, not because they were the biggest but because they would have created a confidence crisis. Also systemic features cannot be analyzed only from the side of the individual financial institutions, or even of a group of parent and subsidiaries, the interdependency of institutions is probably equally important, as one has witnessed that developments in one case may trigger, like a house of card, crises in several other fields, creating a more widespread crisis, extending to several jurisdictions and even worldwide. Herd behavior in the markets is a case in point. Finally one has systemic events: the suspension of redemptions in two investment funds lead to systemic concerns in early august 2008. In se, this event was not systemic, but the time it happened, the surprise it caused, and the identity of the bank that sponsored these funds all explain the extraordinary dimension of the reactions to these decisions. So what is systemic is extremely difficult to define ex ante, and it is probably better that we do not define it too clearly: "constructive ambiguity", that great invention of central bankers, is the appropriate approach here too.

Systemic risk may develop in many quarters of the financial system. But in some it is more likely to occur than in others. The OTC derivative markets are probably the best example of a market segment likely to contain a relatively high dose of systemic risk. This is due to its sheer size, to the mutual dependence, to its unregulated and opaque nature and the weakness of its infrastructure, and the lack of supervision on many of its participants. Moreover it is a market that takes place simultaneously in several parts of the world, with a clear concentration in the US and the EU.

The size of this market is huge: as of the June 2009, the BIS reported as OTC traded contracts a total of $ 604 trillion notional amount, of which 437 were interest rate contracts, 36 CDS, 6 equity linked contracts and 3 commodities contracts[1]. However, as was evidenced in the Lehman liquidation and later CDS auction, the risk volume is considerably less than the notional amounts due to netting of the respective positions.

The derivatives markets in Europe- differently from the US, e.g. for the equity derivatives - are largely over-the-counter markets. Trading takes place directly between market participants, in Europe often in electronic systems. The number of financial institutions, active in these markets as direct participants is very limited, sometimes only a handful – e.g.

1 Based on BIS data, www.bis.org/statistics/derdetailed.htm

for the CDS market, only 5 are counterparties to 50% of the notional outstanding - concentrating positions and risks in few hands. There is no clear price formation, less price transparency, except for the directly involved traders. The products are to a certain extent standardized, but in some segments, absence of standardization is common, and often sought after. Execution of transactions was for some time based on bilateral agreements, and not always clearly followed up. Disputes on the terms of deals were not infrequent.

The financial crisis was the big wakeup call for systemic risks. Derivatives are therefore high on the agenda of regulators and supervisors worldwide. There is wide agreement that risk management and transparency should be enhanced. The G 20 urged fundamental reforms in the OTC derivatives markets2. The European council of 18/19 June 2009 called for further progress on "transparency and stability of derivatives markets"3. The Greek crisis has focused the attention on the market of sovereign CDS. r.

But the fear of systemic risks is only one of the reasons to look more closely at the derivative markets. As derivatives are part of the bank assets or liabilities, the functioning of this market will also affect the position of the bank at a micro prudential level.

In terms of market integrity, of direct relevance to CESR, one should point to the risks of manipulation, of market abuse, of insider trading as illustrated in the Galleon case, and of market abuse linked to the use of derivatives in more complex trading strategies. In commodity markets, position limits in certain commodity derivatives are considered to address possible speculation in essential commodities as oil running too high (see: US CFTC proposed rulemaking, 26 January 2010).

The authorities cannot stand by idle: measures should be adopted to ensure that they have the necessary instruments to avoid unhealthy evolutions to develop and if needed that they are able to combat them. Several steps should be taken, and most are considered these days by the regulators (EU Commission, US Congress). Global coordination is key, due to the global nature of these markets. The CDS market is today the one that is getting the most attention and we will focus on that market.

The first step is to create transparency. In some jurisdictions, post trade transparency Mifid type has already been extended to certain derivatives. CESR has recommended further steps for a harmonized approach to enhanced post trade transparency in credit derivatives markets.
Derivatives trades should be reported to a trade repository, so that all transactions, whether standardized or not are known to the supervisors, and if needed to the outside world. Supervisors should have direct and immediate access up to the level of individual transactions. The repository should also act as the basis for the legal title: as trading implies transfer of a contract, through novation of the debtor, legal certainly should ensure that no doubts about the clean title can arise, e.g. in case of later bankruptcy of the transferor. The

2 *Improving over-the-counter derivatives markets:* All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.

3 *See also the ECOFIN conclusions of 2 December 2009.*

private law aspects of these transactions should be closely analyzed, also with a view of determining the applicable law, too often the law of the state of New York. Finally, netting systems should become mandatory to the greatest extent possible, as this would reduce the volume of outstanding liabilities and hence of the remaining risk in the financial system. This reduction can be achieved through "compression", i.e. bilateral netting leading to annulling the contracts, or multilateral netting in a central counterparty. The latter possibility has been introduced in several markets, and constitutes undoubtedly a step forward. However, it results in concentrating risk in the CCP, and hence the reliability of the system depends on the safety built into the functioning of the CCP. Some recommendations – esp. those of ESCB-CESR - state that the CCP should be able to withstand the failure of the largest clearing members. In highly concentrated markets, where the interconnectedness among clearing members is very high, this standard is too low. One should take into account the failure or several clearing members. This than raises the question whether our financial systems are capable of supporting risks of that magnitude: there is a limit to capital, to collateral, etc. to support the CCP. Therefore one should ask oneself whether it is not indicated to provide for certain limitations of the growth of this market. Some have proposed to require liabilities to be commensurate to the economic risk supported, e.g. by limiting CDS to those parties that have an underlying risk to which the CDS relates. This so-called prohibition of "naked CDS" raises a number of questions. How to define when the CDS is "naked"? What are justified trading strategies? These questions do not receive a clear answer, probably standing in the way of banning specific CDS transactions. Alternatives would be to provide for stricter collateral, limiting the amount of leverage, or other similar safety standards for curbing too hot positions. But this may be ambiguous: for safety reasons, one would prevent the creditors to protect themselves. The G 20 stated that in order to make trading more transparent, trades should be executed on public, open and transparent markets, where appropriate. This presupposes the transactions to be better standardized to make them clearable. Reliable post trade information should be made available: this would allow market participants and supervisors to follow the evolution much more closely. The information should be available on the basis of the transactions stored in a trade repository. In this respect, the European Institutions should debate whether a European solution is to be preferred.

The importance of the systemic risk in the hedge fund sector is a controversial issue. Some have put a large part of the blame of the financial crisis on the hedge funds. The recent financial crisis is not actually a hedge fund crisis; some reports mention that the activities of hedge funds may have amplified the consequences of the crisis.4

The FSA has published an assessment on the sources of systemic risk in the hedge fund sector5, and concluded as follows

- Leverage: the two strategies with the highest ratio represent less than 10% of assets under management
- Borrowing: is on average 202 % of net equity
- Credit risk: the largest exposure to several banks was 1 billion, with a maximum per bank of less than 0,5 billion; prime brokers held excess collateral
- Derivatives were cleared exclusively in CCPs by 16% of the funds; another 70% cleared a portion of traded derivatives in CCPs.

4 See Iosco, Hedge Funds Oversight, Final Report, June 2009, § 14.
5 FSA, Assessing possible sources of systemic risk from hedge funds, February 2010.

The fear for systemic risks in the hedge fund sector stems on the one hand from the LTCM incident, where the Fed had to urge the banks to engage in a rescue operation, on the other from the potential risks that might be created by hedge funds. Herd behavior, e.g. due to fire sales, is sometimes mentioned, but this is common to many institutional investors. As positions can change very rapidly, the risks can also accumulate e.g. by shifting collateral. Recent events in the CDS market may also have sharpened the perception of potentially systemic behavior.

The AIFM does no directly address this issue. The directive mainly consists of submitting hedge funds to a tighter regime of supervision. As the Council is still in the process of deciding on the text of that directive, it is difficult to give a detailed overview.

How then to deal with systemic risks in hedge funds? As this is an unknown quantity, the best one can do is mandate the supervisors to collect and analyze data, and report on these to the bodies in charge of systemic risks. This is precisely what is planned in the framework of the European Systemic Risk Board, as supervisors, to which the future European Securities and Markets Authority will report in the form of aggregate information on major developments in the sector. On the basis of an analysis of overall risks, the Board will issue a recommendation, to be further implemented whether through the supervisors or by the states. As no clear risks relating to hedge funds have been identified up to now, this cautious approach is to be preferred. If measures have to be considered they will certainly apply to a broader sector than the mere hedge funds.

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