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Sent: Tuesday, August 24, 2010 3:49 PM
To: 'Darrell Duffie'
Cc: Radhakrishnan, Ananda
Subject: Minimal size of clearing members

Ananda,

Thanks for a very stimulating meeting on Friday. I appreciated the invitation.

As you may have gathered from my comments, I am somewhat skeptical of Jim Hill's claim during the meeting that for safely unwinding a failing member's positions, one should only have clearing members with large total capitalizations.

Let's suppose the threshold for Jim's story (about the unwind capacity needed to safely handle failing CMs) is a capitalization of \$1 billion, just for illustration. And let's suppose we have already signed up, say, 10 of these big clearing members (CMs). Now we can consider whether smaller market participants, who meet the requirements of creditworthiness and risk management sophistication, can be safely added as clearing members.

1. Are 20 more CMs, each with a capitalization of, say, only \$0.5b no help at all with the unwind? Why not? Is there no chance that they would want to bid for the failing member's positions? If not, why not? If so, then the total unwind capacity of the membership is increased by including these medium-sized CMs.
2. Are the original 10 CMs worse off when the 20 new ones come in? If so, is it because the 20 are competing away some of the profit of the big CMs, or something else? What are the causes of losses to the big CMs?
3. Suppose for sake of argument that the 20 new CMs are indeed useless at unwinding failing positions, and that they are sharing in the other benefits of being a CM, while not participating in unwinds. In this case, is there free riding? That is, are the big CMs actually bearing a new cost with each new unwind that is not borne by the small CMs? What is the source of this cost? The unwind auction is beneficial to the CMs that participate, provided their bids are rational and can be paid with the resources of the guarantee fund. The risk is that the guarantee fund (to which the smaller CMs contribute) is not big enough to pay the big CMs. Provided it is a big CM that fails, not a small one, would you not rather have the small CMs contribute to make a bigger guarantee fund? If it is a small CM that fails, there should be no problem unwinding its positions.
4. Suppose for sake of argument that the big CMs are indeed worse off with the participation of smaller CMs. Is there not still room for a net gain in economic efficiency from the participation of small CMs? By definition, if they want to join as CMs, they have a gain from becoming CMs. Do we know that their gain is smaller in aggregate than the total loss of the big CMs? If net gain is positive, then side payments (e.g. higher proportional clearing fees for small CMs, or some sort of unwind cost sharing) could net the social efficiency gains.

I think these questions need to be better addressed before we give up on allowing (or mandating) more clearing participation. This is, in my view, a very important policy issue.

Large CMs, which tend to be dealers, may have a conflict of interest in claiming that smaller CMs are unsafe merely because of being small. A smaller or medium-sized market participant would be in a better position to execute trades directly with a third party if the third party is able to novate the trade to a CCP. (Otherwise, the third party would need to manage counterparty risk with the smaller participant, which is less attractive than managing counterparty risk with a CCP.) If the smaller market participant is not a clearing member, then the opportunity to novate to a CCP is reduced or eliminated. Thus, allowing smaller CMs introduces more competition between large dealers and smaller market participants. That may be a good thing to allow. Moreover, having more exposures cleared may be good. Also, if CCPs controlled by large CMs refuse to allow smaller clearing members, there is a risk that smaller market participants would seek to form their own CCP, further disaggregating clearing and causing lost opportunities for netting, and more CCPs for regulators to supervise, potentially reducing the quality of regulatory supervision.

Best

Darrell