

Regulatory Arbitrage in Derivatives Reform

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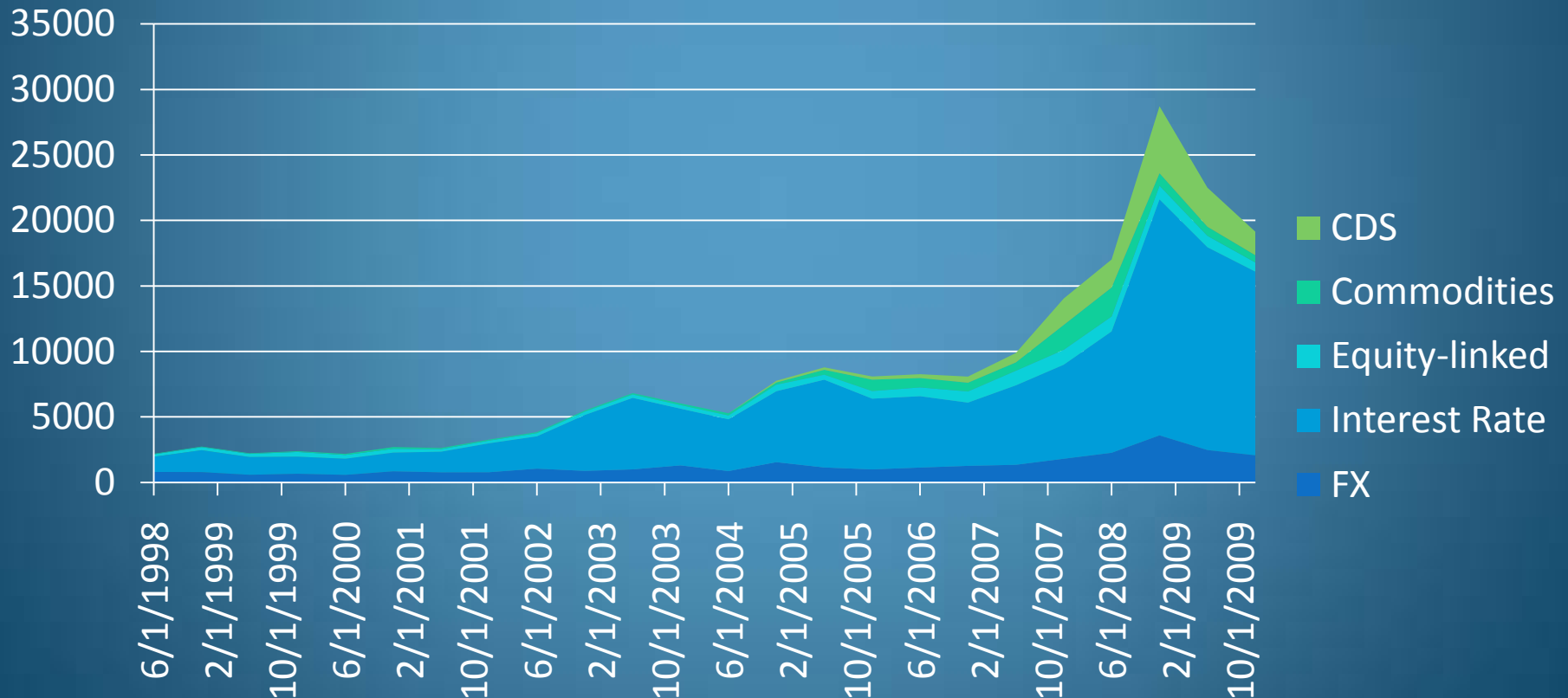
Three Main Themes

- Quantitative Data: not a clear case for reg arb
- Historical Data: financial firms aren't the only arbitrageurs
- Back to the Future: Importance of scenario analysis

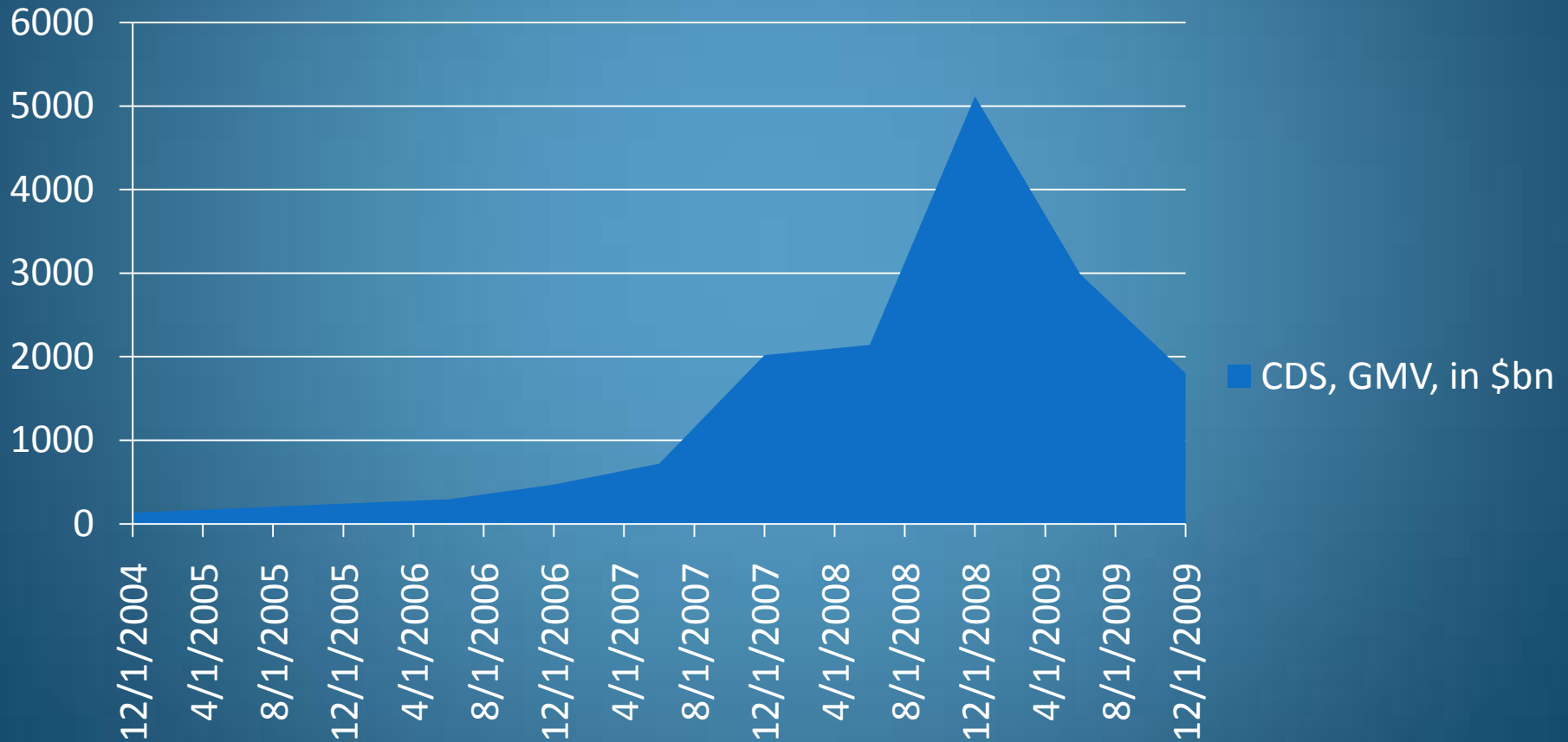
Basel 1 – 2 – 3: Regulatory Arbitrage

- 1970s – 80s: lending (especially real estate lending) is risk; trading is good
- 1988 - 91: Risk-based regulatory capital
 - 0, 20, 50, 100
- 1990s: model extensions; trading increases
- 2000s: credit is traded; more risk-based capital; one major meltdown still underway...trading is bad, real estate lending is good

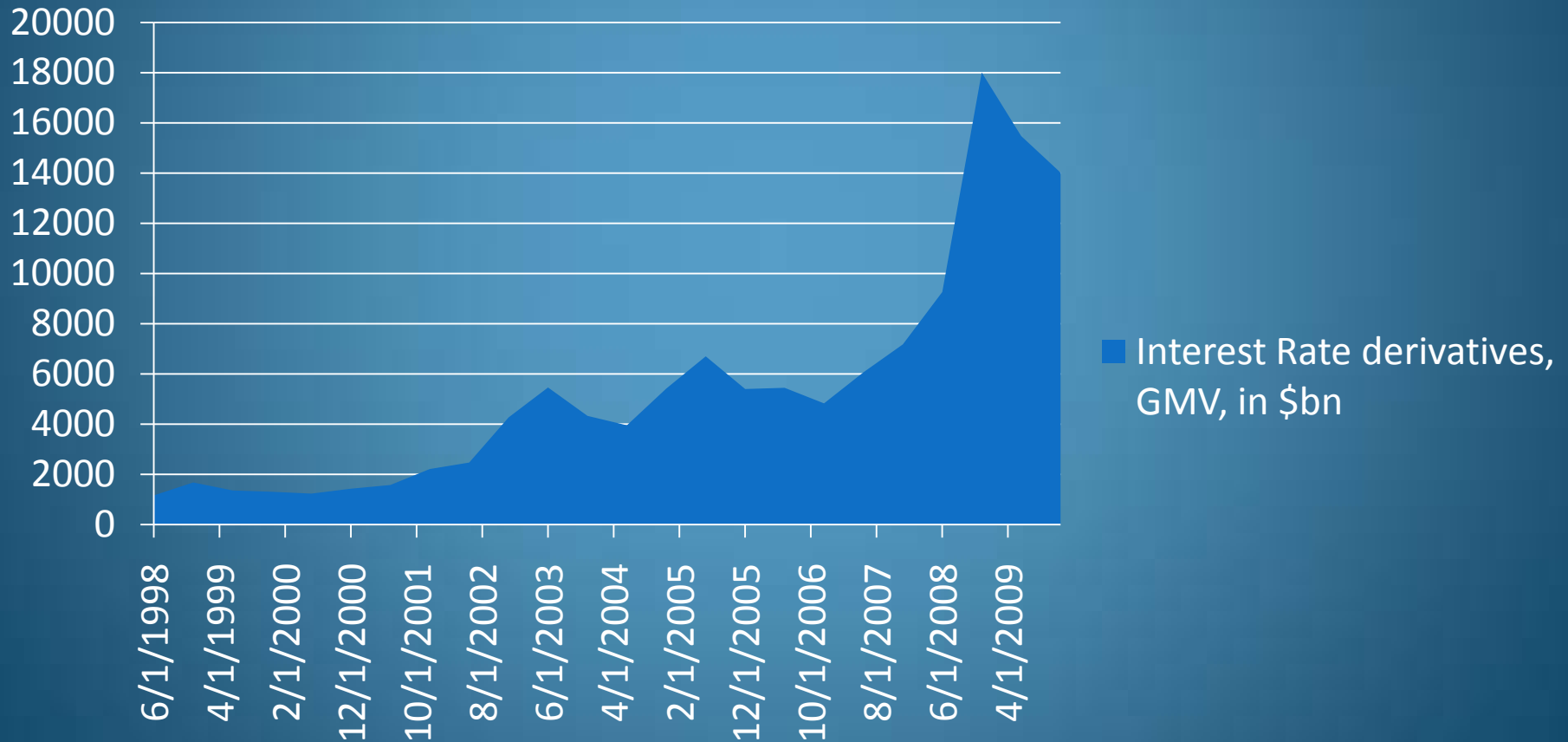
Just the Facts -- the overall picture



CDS, GMV, in \$bn



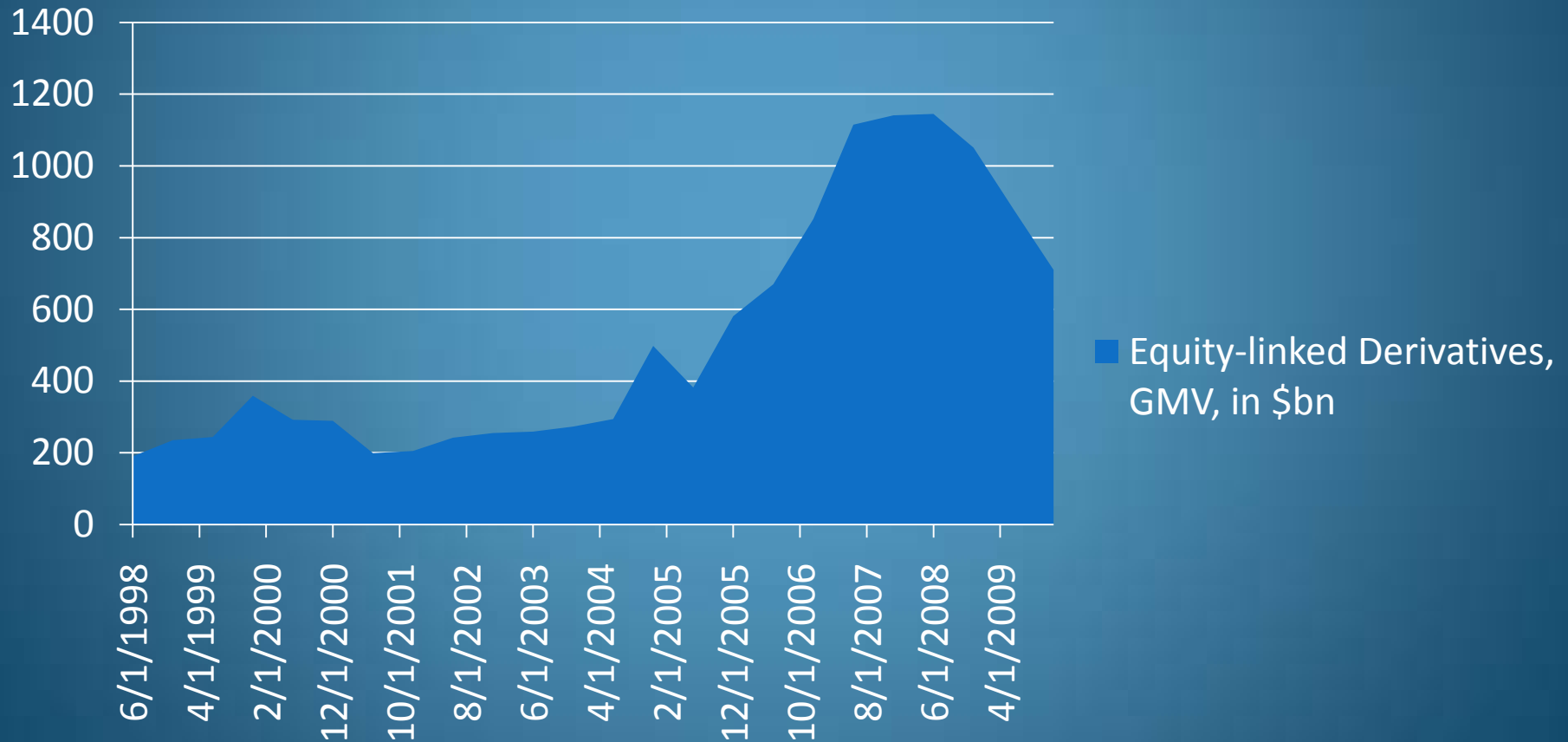
Interest Rate derivatives, GMV, in \$bn



FX derivatives, GMV, in \$bn



Equity-linked Derivatives, GMV, in \$bn



Fannie Mae & Freddie Mac: Regulatory Arbitrage

- | | 2009 Total | 1Q2010 |
|-------------|--------------|----------------|
| Fannie Mae | \$60 billion | \$8.4 billion |
| Freddie Mac | \$51 billion | \$10.6 billion |

Scenarios for Regulatory Arbitrage

- Volker Rule & Lincoln Amendment v. AIFM
- Regulatory capital treatment of sovereign debt
- Treatment of credit rating agencies
- Resolution mechanisms
- Financial Sector taxes

Definitions

Mirriam Webster: Main Entry: **1ar·bi·trage**

Pronunciation: \är-bə-träzh\ Function: *noun*

Etymology: French, from Middle French, arbitration, from Old French, from *arbitrer* to render judgment, from Latin *arbitrari*, from *arbitr-*, *arbiter*

Date: 1875

1 : the nearly simultaneous purchase and sale of securities or foreign exchange in different markets in order to profit from price discrepancies

2 : the purchase of the stock of a takeover target especially with a view to selling it profitably to the raider



Definitions

The Economist: Regulatory Arbitrage

Exploiting loopholes in Regulation and perhaps making the regulation useless in the process. This is often done by international investors that use derivatives to find ways around a country's financial regulations.

Multivariate Analysis

Group of Twenty

IMF

BIS

- Basel Committee
- CPSS
- CGFS

OECD

Systemic risk regulators

Financial Stability Board

National Regulators & Finance ministries & Central banks

World Bank

Standard Setters

- Basel Committee
- IASB
- IOSCO
- IAIS
- IADI
- IFIAR

Did You Know....

Cost estimate of crisis: \$100 billion

Possible total cost, including permanent losses to GDP in some countries: \$60 – 100 trillion

Risk Management Questions

- Official sector use of credit risk models to measure systemic risk contributions and charges to cover those contributions: fact or fiction?
- How should corporate credit be assessed in countries that are large issuers of sovereign debt?
- Are data sets still valid
 - If pervasive fraud existed in a particular market?
 - If sovereign interventions and market activities corrupt databases?

More Risk Management Questions

- What impact will shrinking/more expensive bank trading activities have on your hedging and risk intermediation activities?
- How would your view of intra-group and counterparty risk shift if the firm was required to operate in different jurisdictions through ring-fenced subsidiaries?



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