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ICE Clear Europe Limited; Notice of Filing of Proposed Rule Change to Clear Western European Sovereign CDS Contracts

Comments submitted to the SEC by Darrell Duffie, Stanford University. November 7, 2012.

1. The trading and safe clearing of credit default swaps on European sovereign debt offers a valuable ability to investors of various types to partially insure themselves against losses they may incur through the default or restructuring of sovereign debt. The publicly disclosed pricing of these contracts also offers helpful information to market participants and others concerning the creditworthiness of the underlying sovereigns. Provided the counterparty risks of these contracts are safely managed, social welfare is likely to be improved by enhancing the ability of market participants to obtain clearing services for these contracts.

2. Collecting margin in dollars (rather than Euros), and refusing clearing services to parties directly affiliated with the underlying sovereign, are key first steps toward mitigating wrong-way risk. These steps are already included in the application. I suggest consideration also of the wrong-way risk associated with clearing the protection-sold contract positions of banks and other entities whose credit-worthiness or liquidity may be significantly correlated with the underlying sovereign. In many cases, European banks have granted significant credit (including through their bond investments) to European sovereigns. Even if such banks are in fact technically solvent, uncertainty by depositors and other investors about that fact can lead to various forms of runs and demands for extra liquidity that can lead to a bank's failure near the time of the sovereign's failure. I believe that the applicant should periodically prepare an analysis of any potential such cases, share this analysis with its primary regulator, and rule out the provision of clearing services wherever the wrong-way risk is judged by the clearing agent or its primary regulator to be significant. In addition, the applicant should provide its primary regulator and the public with regular reports concerning exposures of this correlated type, at least in aggregate. For example, the applicant could report, say on a weekly or monthly basis: "We currently have cleared positions representing an aggregate notional amount of XXX million Euros, by which banks and other financial institutions have sold protection on a sovereign in which they are domiciled, or to whose failure they are otherwise believed to have substantial financial or other business exposure." As background, I recall reading about the tenuous positions of investors who, just before the onset of the Asian debt crisis, had purchased foreign currency put options on Korean Won from counterparties that were Korean banks.

3. Regarding risk management in general, I do not find that ICE Clear Europe, and other major clearing agencies, have provided sufficiently detailed information about their default management plans, including the associated quantitative parameters, for investors to fully understand these plans. This concern is not specific to the clearing of sovereign CDS. Much more detailed disclosure would improve the ability of the public to monitor the risk management quality of these institutions. This is in the public interest. Even if regulators are judged to be fully capable of monitoring these default management plans on their own, a further potential lowering of investor uncertainty about these plans, through the ability of others to perform detailed analyses based on publicly available information, lowers systemic risk.

4. Regarding the underlying sovereign credit default swap contracts, I have found that these contracts are not well designed to treat cases in which a sovereign's restructuring removes from the marketplace so many "legacy" deliverable bonds that the settlement of the contracts results in extremely poor hedging effectiveness. Such a situation arose earlier this year, with the restructuring of Greek sovereign bonds, which effectively eliminated almost all legacy bonds in the "open market," replacing them with a package of instruments, only some of which were deliverable in settlement of the CDS. The new deliverable instruments could easily have had a delivery value that bore little resemblance to the effective recovery value to legacy bond holders. It was only by sheer luck that there happened to be a resemblance in valuation in this instance. For further details, including a specific design proposal, please see my essay, with Mohit Thukral, "Fixing the Flaw in Sovereign CDSs" , *Risk Magazine*, July, 2012.