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Highlights

Highlights of GAO-09-397T, a testimony to Congressional Requesters

SYSTEMIC RISK

Regulatory Oversight and Recent Initiatives to Address Risks Posed by Credit Default Swaps

Why GAO Did This Study

The U.S. financial system is more prone to systemic risk today because (1) the current U.S. financial regulatory system is not designed to adequately oversee today's large and interconnected financial institutions, (2) not all financial activities and institutions fall under the direct purview of financial regulators, and (3) market innovations have led to the creation of new and sometimes complex products that were not envisioned as the current regulatory system developed. Credit default swaps (CDS) are one of the products that have assumed a key role in financial markets.

My statement will discuss (1) the extent to which U.S. financial regulators and the UK regulator oversee CDS, (2) risks and challenges that CDS present to the stability of financial markets and institutions and similar concerns that other products may pose, and (3) the recent steps that financial regulators and the industry have taken to address risks pose by CDS and similar efforts that may be warranted for other financial products. GAO reviewed research studies and congressional testimonies. We interviewed financial regulators and a variety of financial market participants.

In January 2009, GAO designated the financial regulatory system as a high-risk area in need of congressional attention. Issues involving systemic risk regulation in general and CDS in particular should be considered as part of that effort.

View GAO-09-397T or key components.
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What GAO Found

The current regulatory structure for CDS does not provide any one regulator with authority over all participants in the CDS market, making it difficult to monitor and manage potential systemic risk. Federal oversight of CDS trading and monitoring of the CDS market are largely conducted through the banking regulators' safety and soundness oversight of supervised banks that act as CDS dealers. The Securities and Exchange Commission and the Commodity Futures Trading Commission lack the authority to regulate CDS broadly as financial products. Regulators have sought to address potential systemic risks arising from CDS activities mainly through collaborative efforts with other supervisors and key market participants. However, the extent to which regulators routinely monitor the CDS activity of unregulated market participants is unclear. The Financial Services Authority in the United Kingdom has authority over most CDS products and can collect information about the CDS market, but it has pursued most of its regulatory efforts in collaboration with U.S. regulators.

CDS pose a number of risks to institutions and markets, many of which are not unique. These include counterparty credit, operational, concentration, and jump-to-default risks. Market participants and observers noted that CDS referencing asset-backed securities (ABS) and collateralized debt obligations (CDOs), particularly those related to mortgages, currently pose greater risks to institutions and markets than other types of CDS. Other risks and challenges from CDS relate to the lack of transparency in CDS markets, the potential for manipulation related to the use of CDS as a price discovery mechanism, and the use of CDS for speculative purposes. Regulators and market participants noted that over-the-counter (OTC) derivatives, to varying degrees, may pose some similar risks and a few identified equity derivatives as the OTC derivatives that were most similar to CDS.

Financial regulators and market participants have initiated several efforts to mitigate these risks. These efforts target primarily operational and counterparty credit risks and include improving the operational infrastructure of CDS markets, creating a clearinghouse or central counterparty process to clear CDS trades, and establishing a central trade registry for CDS. If effectively implemented and sustained, these initiatives could begin to address some of the risks noted. But the effectiveness of these recent initiatives could be limited because participation is voluntary and regulators lack the authority to require all market participants to report their trades to a repository. Moreover, customized and highly structured CDS, which can include CDS with complex reference entities that may present additional risks, generally lack the standardization necessary for centralized clearing. Other ideas to reform CDS markets, such as mandatory clearing or limiting some types of trades, have important limitations that would need to be addressed. Finally, many participants and observers agreed that OTC derivatives other than CDS generally share some of the same risks and could benefit from similar efforts to mitigate their impact.