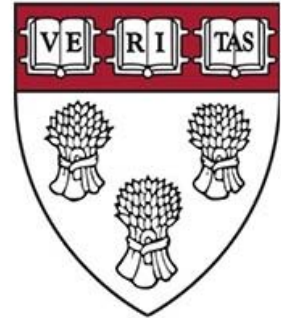


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Derivatives and Collateral: Balancing Remedies and Systemic Risk

Posted on [November 4, 2014](#) by [Editor](#)

By [Steven L. Schwarcz](#), Duke University School of Law



Professor Schwarcz examines whether the bankruptcy “safe harbor” for derivatives is necessary or even appropriate to protect against systemic risk—such protection being the safe harbor’s articulated justification. The article examines the most important function of the safe harbor: allowing derivatives counterparties to exercise their contractual enforcement remedies against a debtor or its property notwithstanding bankruptcy law’s stay of

enforcement actions. A threshold question is whether there is anything inherently risky about derivatives that might cause a systemic failure.

The standard answer is volatility. But, the article observes, regulation could reduce that potential for systemic risk in a more limited fashion. The article next addresses the safe harbor from the standpoint of its impact on avoiding contagion. The safe harbor is supposed to enable large derivatives dealers to enforce their remedies against a failed counterparty, thereby minimizing the dealer’s losses and reducing its chance of collapse.

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There are, however, several flaws in the safe harbor's design to accomplish that. First, the safe harbor incentivizes systemically risky market concentration by enabling dealers and other parties to virtually ignore counterparty risk. Second, the safe harbor operates independently of the size of the counterparty or its portfolio. The article then examines how the Lehman bankruptcy might inform the safe harbor debate. The article offers a final caution: To the extent the safe harbor might amplify, rather than protect against, systemic risk, its negative impact would transcend the traditional derivatives market.

The full version of this article is forthcoming from the University of Illinois Law Review and is available in draft form [here](#).

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- [December 2015](#)
 - [November 2015](#)
 - [October 2015](#)
 - [September 2015](#)
 - [August 2015](#)
 - [July 2015](#)
 - [June 2015](#)
 - [May 2015](#)
 - [April 2015](#)
 - [March 2015](#)
 - [February 2015](#)
 - [January 2015](#)
 - [December 2014](#)
 - [November 2014](#)
 - [October 2014](#)
 - [September 2014](#)
 - [August 2014](#)
 - [July 2014](#)
 - [June 2014](#)
 - [May 2014](#)
 - [April 2014](#)
 - [March 2014](#)
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