Commentary

OTC Derivatives Don't Need Fixing

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Reining them in will not prevent the next financial crisis but will cripple the financial markets and curtail economic growth.

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The current version of the financial regulation bill in Congress is based on a serious misunderstanding of the workings of derivatives markets, their economic raison d'etre and their value to society. Advocates of the bill, including prominent economists and regulators, have been lobbying vigorously for it--writing op-ed pieces and promoting an overly burdensome and counterproductive federal regulation of derivatives regardless of whether the financial crisis was even caused by derivatives.

The growth and prosperity that we have witnessed in the past 30 years is due substantially to the development of global financial markets, with financial innovations playing a major role. Derivatives are the centerpiece of these innovations. The attempt to rein in this huge market will not prevent the next financial crisis but will cripple the financial markets and in turn curtail economic growth.

It is true that the bill focuses on over-the-counter and not on exchange-traded derivatives. The reason given is that the opaqueness and complexity of OTC agreements conceal the potential buildup of systemic risk that may lead to epidemic financial crises. The alleged culprits have been CDOs (collateralized debt obligations) and CDSs (credit default swaps). Yes, these instruments were at the heart of some gigantic institutional failures, but the problems were not with the derivatives but with the institutions that used them. AIG, Lehman and others who failed to manage

their risk are the true culprits--not the CDS, which is just a straightforward insurance contract against a default.

In fact, all OTC markets worked well before, during and after the crisis. Foreign exchange, interest rates, commodities, equities--these are all huge markets in notional terms, over $700 trillion. The interest rate swap market alone was about 10 times the size of the CDS market at its peak. Nevertheless, the legislation targets all OTC derivatives claiming that each can potentially lead to a systemic financial disaster.

The solution proposed by the bills is to push all OTC derivatives to exchanges, at least to clearing houses. There is no doubt that exchange-traded derivatives have the advantages of liquidity and safety (the exchange's clearing house is the counterparty). However, the biggest disadvantage is that trading on an exchange requires that all contracts have the exact same terms, what is called standardization. Over 90% of commercial firms in the U.S. use derivatives to hedge risks, and for almost all of them customization is the key feature, which outweighs the need for liquidity and the protection of a clearing house.

An airline has no use for the standardized crude oil futures contract to hedge its jet fuel needs. Airlines need customized forward contracts where they can specify the exact terms that will provide them with the specific commodity, date and location of delivery, and so forth, which cannot be part of a standardized futures contract. This is as true for commercial firms as it is true for financial institutions like pension funds, mutual funds and the like. The need for customization, not appreciated by many academics and regulators, cannot be satisfied by contracts on exchanges. Forcing hedgers to only use exchanges will leave them with risks that they may not want to bear, which will in turn curtail the size of their operations and economic growth.

The more sensible, yet problematic, idea is to have the OTC contracts placed on the books of a clearing corporation (CC). These customized contracts, however, may not be accepted by the CC. The CC is a cooperative, and as such it admits members after checking their credentials and later monitors their credibility. You cannot force the cooperative to admit anyone or any contract that has been drafted even between members of the CC.

Counterparties to OTC transactions who find that the benefit of going to a CC, like eliminating counterparty risk, outweighs the costs, will do so, and there is no need to legislate it, which, as I argued, will be counterproductive. Moreover, the reduction or elimination of OTC contracts will affect the liquidity on the exchanges that dealers use to hedge their risk of an OTC trade.

So how are we going to oversee "systemic" risk that could be created by one or a few "irresponsible" institutions using opaque derivative instruments?

The answer is transparency. This could be achieved by creating a centralized registry where OTC trades will be registered. Some form of aggregate information should be available to the public and more detailed information should be available to the regulators. This should be sufficient for corporations and financial institutions to assess their counterparty's risk and alert the regulator in the case that systemic risk is building up.

In summary, forcing OTC contracts to be placed on exchanges or CCs will make commercial corporations and financial institutions reduce their hedging activities while others will seek alternate costly refuge in foreign jurisdictions. The result will be fewer investments in this country and an impaired economic outlook.