



## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**The social utility of derivatives: A round-table discussion with Paul Wilmott (Wilmott Associates), Anthony Belchambers (FOA), Richard Metcalfe (ISDA), Stewart Hodges (Cass Business School), Simon Davidson (Credit Suisse) and John Grout (ACT). Held on Monday, November 23, 2009, at Innholders Hall, 30 College Street, London EC4R 2RH, from 12:30-2:15 pm.**

Drawing inspiration from a previous round-table, during which a speaker made some fairly dismissive comments about the role of financial derivatives, a large group of speakers and attendees gathered to discuss the social usefulness of derivatives. Whilst all members of the panel agreed that derivatives had a role to play in the financial sector, there were a number of differences over the extent to which some of the more complex products posed a potential threat to financial stability.

Most speakers noted that they existed because they were needed. One speaker recognised their usefulness with the proviso, however, that one could not take the quality of markets for granted. So whilst he did not support the abolition of derivatives products he did feel that the potential for market manipulation had to be recognised. This concern pointed to the need for well functioning (in terms of depth and liquidity) markets. When markets failed, the derivatives products failed as well.

CDO squared (essentially a collateralised debt obligation underpinned by a different pool of collateralised debt obligations) was used by the speaker as an example of a product where the contract was too opaque and complex. He failed to understand how they flew in the first place and for so long? This, he felt, was an example of a trade that was without purpose. He emphasised that his concern for the quality of markets applied to all markets. One couldn't assume that markets would take care of themselves.

Accounting driven trades, in which there were two offsetting transactions on the books within the same institution that make a profit in aggregate, were given as another example of a trade that was without purpose and should not happen (and should, in fact, sound alarm bells to regulators). And while he noted that credit rating agencies had performed poorly, hindered by poor or perverse incentives and poor knowledge, they were not the root cause of crisis. The same speaker was quick to point out that the main failure in the recent crisis lay with the authorities who had been responsible for letting a credit boom get out of hand.

A number of the speakers also provided some insight into the fact that although derivative products have been used for a very long time, their rapid growth since the 1970s was linked to the freeing up of exchange rates and floating interest rates. One speaker pointed out that the vast majority of derivatives products had quickly become standardised. Another highlighted that it was a problem of people, not products, and wondered why, after centuries of use, we were still debating their usefulness. Far from being a champagne product, derivatives allowed for risk management across the

economy. A large number of organisations utilised derivatives to manage trading risks. The issue of regulation, he claimed, had to be separated from social value.

The issue of regulation was addressed by all of the speakers. One noted, however, that caution was needed. Regulation itself can generate complexity and he pointed to extremely long prospectuses, which had to satisfy regulatory requirements, as an example of that. He also noted that credit derivatives had helped industry through the crisis by allowing for the pricing of corporate risk.

He also addressed the issue of moving OTC trades onto exchanges (a subject that will be explored further in a CSFI round-table on January 12, 2010). He again noted that caution was needed as the resulting standardisation of products could lead to inefficient hedging and may not suit some corporate clients.

The issue of complexity was raised by all the speakers. One pointed out that some derivative products were complex because the underlying risks they were addressing were complex. He noted that financial institutions should neither buy nor sell a product that they did not understand. Others felt that complexity created opportunities for abuse. A number of the speakers noted that this issue again pointed to the need for better corporate governance and prudential capital requirements.

One speaker, however, felt that the issue of complexity was not at the heart of the problem. There was, he noted, nothing that derivative products did that could not be done with other, existing products. He questioned the notion that they had inflicted damage on the financial system and asked where were the worthless derivatives? Whilst agreeing that there was room for regulators to do more, he used AIG as an example of the failure of management oversight as opposed to problems inherent to the products. Information on the build up of exposure needed to be pulled together and given to supervisors.

Another speaker, however, differed sharply with this view. He noted that complexity, i.e. bundling, was always in favour of the supplier, not the consumer. He also pointed out that non-financial companies rarely used complex derivatives. One member of the panel shared this view and felt that both size and complexity were the major problems. He noted that the notional size of the derivatives market was over \$600 trillion (though the relevance of this number was disputed by another member of the panel). Given the way derivative products were structured, he felt that the link between value and price was obscured and that there was an overly strong incentive to keep selling. Though he recognised the usefulness of derivatives, he felt that the optimum size of the market was probably much smaller.

Another speaker noted that there had already been shrinking activity in the derivatives market and that had been motivated by reactions in the market instead of regulatory action. Most panel members agreed, however, that new regulation was on the horizon and were concerned about its shape and impact.