

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

Derivatives trading: A round-table discussion with Anthony Belchambers (FOA), Max Butti (Liquid Capital), Henry Hunter (Markit), Richard Metcalfe (ISDA) and Jeremy Grant (FT), held on Monday, November 17, 2008, at Armourers' Hall, 81 Coleman Street, London, EC2R 5BJ, from 12:30-2:15pm.

The theme of the discussion was the danger of “throwing the baby out with the bathwater” – the potential loss to the economy of a severe curtailment or abolition of the use of derivatives because of the anger over their role in the credit crunch. The problem was with people not the product, the first speaker said. He used a car analogy, saying that a safe family car that had been modified with a V8 engine and driven by a boy racer was more dangerous than a high-speed racer or a 4x4.

One key issue up for debate was the need for a central clearing system for credit default swaps (CDS) and other over the counter (OTC) products as a way to resolve the problem. The speaker said there was no silver bullet as there were multiple causes for the crisis including risk assessment, due diligence, valuation, volatility etc. The idea of targeting speculative or financial trades was nonsense, as those participants added liquidity to the market and lowered the cost of capital.

The second speaker said an example of misguided intervention was the ban on short-selling that did not halt the fall in financial stocks, and might have contributed to it. Picking up the car analogy, he said what was important was what was under the bonnet. It was possible to take several vanilla products but put them together in a way that was dangerous. It is the complexity that harms transparency and intensifies risk and so it is complexity that regulators should seek to tackle.

Some members said surely the industry did not want the Financial Services Authority to pre-approve all products rather than just regulate the firms providing them. The speaker said the idea was not detailed pre-approval but a regulatory focus on rising levels of complexity. In terms of a central clearing system he was in favour of taking all simple products and putting them through an exchange. The third speaker said the issue with a central clearing system was counterparty risk. A good model was the LCH interest rate swap clearing system. A clearing system for derivatives would not have prevented the crisis but it might have tempered the worst aspects of panic.

The fourth speaker said figures from the Bank of International Settlements showed derivatives obligations were some \$4 trillion, a fraction of equities or bonds. He said counterparty risk – the risk of default by another party to the deal – was a key issue post-Lehmans but was not new. Basel I stipulates banks should hold assets against counterparty risk. One member said a fundamental question was how much derivative trading was sustainable in the new “puritanical” environment and how much needed to disappear. The fourth speaker agreed lower volumes of proprietorial trading was inevitable

while some firms would disappear. However he doubted derivative trading itself would disappear.

The fifth speaker said the industry had been terrible at explaining itself. He referred to a US Senate debate on derivatives following the Enron crisis when Trent Lott read out a dictionary definition of a derivative as “the limit of the ratio of the change in a function to the corresponding change in its independent variable as the latter change approaches zero”. He warned against rushing to legislate on areas that they didn’t fully understand. One member asked how the industry should defend itself. The speaker said it was too late for defence: the issue was to explain as the crisis worked through. CDSs are debated on the BBC Today programme – something unimaginable even six months ago.

One member said that, like it or not, politicians wanted to find a scapegoat and to impose regulation that would only prevent a recurrence of the last crisis but not the next one. While the European Commission was pushing ahead with new regulations designed for a credit explosion not a credit crunch, it was sad to see the US and UK leading the regulation drive, he said.

What would the panel do to maintain the derivatives market? The first speaker said clearing was a well-recognised and tested system and would be useful as long as people did not think a clearing system would of itself eliminate counterparty risk. The third speaker agreed with the need for a clearing system and a focus on transparency and education. The second speaker hammered home the need for regulation of complexity. The industry should get better at education and at producing simple well-regulated, easy to understand products. The fourth speaker agreed on the need to educate and explain what derivatives do, and the idea of risk transfer. As with Tony Blair’s New Labour, the mantra seemed to be “Education, education, education.”