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EDITORIAL COMMENTARY

A New Form for Risk Are these derivatives over-the-counter, or under it?

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WITH GENERAL MOTORS seemingly in danger of bankruptcy as gasoline prices rise toward \$4 per gallon, many investors are seeking some kind of cover against a default by the world's largest auto maker. The market obliges: For about nine cents on the dollar of bond principal, down from 12 cents a month ago, investors can buy a year of insurance against GM's seeking protection from its creditors. Whether this sounds like a great deal or a new form of usury, the risks posed to all investors by the burgeoning credit-derivatives market bear closer attention.

To many free-market advocates, the derivatives markets represent the best of financial innovation, a flexible way for investors and corporations to parse their risks and maximize returns. But there are excesses now visible in the over-the-counter derivatives markets that bear remarkable similarity to the speculative manias fueled by private investment pools in the U.S. a century ago -- manias that led to financial crashes and the eventual imposition of market regulation by a shocked and outraged Congress.

Last September, the big dealers in OTC derivatives met at the Federal Reserve Bank of New York to discuss problems faced by the fastest-growing part of that market for credit default swaps, or CDS. The dealers subsequently proposed requiring hedge funds to adopt standardized trading and settlement procedures for derivatives trades, in order to reduce systemic risk to this vast market.

Insufficient Zeal

A report sponsored by an industry group headed by former New York Fed chief Gerald Corrigan (read it at <http://www.crmpolicygroup.org>) spends many pages suggesting adoption of practices and procedures that already apply to the rest of Wall Street. Although admirable, the group's recommendations do nothing to reduce the real deficiencies that continue to make derivatives inefficient, opaque and therefore dangerous to investors -- deficiencies that a public marketplace would eliminate.

The Corrigan report notes that while dealers may believe their hedge-fund customers have sufficient collateral to meet their obligations, "once seemingly generous amounts of margin or collateral" can be called into question when "the combination of falling asset prices and the erosion of creditworthiness causes market participants to commence risk-

mitigation efforts such as position liquidations." Such a withdrawal of liquidity is what killed the hedge fund known as Long Term Capital Management.

Many of the report's proposals are being adopted, but they don't address other basic problems in the OTC derivative markets: The lack of transparency in information about prices and trading volume, and the uncertain credit standing of many participants.

The CDS market hardly existed five years ago, but last year grew 40%, reaching \$17 trillion in outstanding contracts as of December 2005, according to the International Swaps and Derivatives Association. CDS traders buy or sell insurance on defaults, usually in million-dollar increments over five-year terms. Spreads on these products track bond yields, and vary depending on the dealer and the customer.

Say a bank has \$10 million in exposure to GM. The bank can lay off part or all of the default risk to another bank or, more likely, a hedge fund, and then think itself risk-free. But the bank's overall risk has increased, because it added a new leg to the original bilateral credit relationship. Where once the bank had only to worry about GM, now it must worry about GM and the hedge fund.

Looking Backward

When custom derivatives were created in the mid-1980s, hedge funds were few and nearly invisible. Not many banks were willing to play in the OTC derivatives market. Virtually all trading in derivatives was conducted on exchanges, organized markets where contracts are fungible, pricing and volume information is transparent, and clearing members who own the exchanges take responsibility for the creditworthiness of their customers.

Trading in OTC derivatives has exploded to account for a third to a half of the \$96 trillion in derivatives traded by U.S. banks. Major banks in the U.S. and European Union derive, if you'll pardon the expression, a significant portion of earnings from trading OTC derivatives, both for their own accounts and for customers, largely hedge funds, which now number in the thousands.

A year ago, when GM and Ford were downgraded by the major credit-rating agencies, shocks rippled through the CDS market. Regulators asked dealers and hedge funds questions about CDS exposure, but answers proved elusive, partly because settlement of credit-derivatives swaps contracts must be processed by lawyers, one by one. The subsequent default by GM supplier Delphi pushed GM and Ford bond spreads into the stratosphere, adding further stress to the CDS markets, but both have since rallied strongly.

One key issue that drove the larger dealers to recommend reforms to the derivatives market was the alarming practice of assigning CDS contracts, in some cases multiple times: For example, a bank might buy credit default protection on GM from a first-rate hedge fund, which then assigns the contract to a smaller fund with an inferior credit

rating -- sometimes without giving notice to the bank. Because the contracts aren't cleared electronically, the result is a backlog of trades and an imprecise risk picture. Indeed, last month, former Fed Chairman Alan Greenspan expressed shock at antiquated CDS settlement procedures that rely on "19th-century technology."

In an interview last year, Corrigan said that while it is possible to standardize much of the settlement for CDS contracts, trading them on an exchange "would not be possible," a view echoed by many of the major dealers. But end-users among the bank and fund community, who mostly commented off-the-record on this analysis for Barron's, believe an exchange-type structure must eventually be adopted to avoid the systemic-risk issues.

Since highly leveraged hedge funds are the predominant sellers of CDS contracts to banks, a growing portion of the aggregate credit risk of the U.S. banking system is held by unregulated, undercapitalized players who have little incentive to limit risk.

If some hedge funds are window-dressing their performance with premium income from CDS sales to banks to prevent investors from withdrawing funds, then it's a situation not unlike the moral hazard that faced insolvent savings and loans two decades ago.

Fair Play in Finance

There is little incentive for the big OTC dealers, like Corrigan's employer, Goldman Sachs, to press their most profitable clients to change their risky behavior. The OTC derivatives markets and especially CDS are the final frontier for Wall Street, one final market where pricing data are closely held, spreads are humongous and customers are at the mercy of the dealer banks.

Robert Schott, senior capital-markets dealer for Landesbank Baden-Wurtemberg in New York, complains that some prime clients of major CDS dealers receive tighter price spreads and access to market-turnover data not available to other investors. Isn't this a direct violation of the well-established American tradition of equal access to information for all investors?

Other CDS traders complain that dealers allow prime clients to buy their way out of losing trades on names like Delphi via cash settlement, while refusing this option to other customers.

Congress and the Securities and Exchange Commission should subject OTC derivatives and the hedge funds in that market to the same regulated openness as exchange traded derivatives. OTC derivatives don't deserve special treatment in a regulatory vacuum. As the Corrigan group's report makes clear, the risks to the global financial system are very great.

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