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Anyone up for OTC Derivatives Regulation?

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Several factors account for the continued call for regulation of the over-the-counter (OTC) derivatives market, not the least of which is the size of this growing market.¹ Derivatives traded outside an exchange have non-standard terms and are not subject to mandatory daily settlement. Recently publicized losses involving derivatives have added fuel to the fire. For example, even though Enron was a major player in the energy derivatives market, it did not have to comply with the reporting or capital requirements imposed on banks. This meant that much of Enron's derivative instrument activity was unknown to investors. It's not surprising then that many lawmakers, already jittery about the prospect of a market meltdown in a soft economy, have responded by proposing additional regulation.

As this column goes to press, both the U.S. House and Senate are working on OTC derivatives market regulation. Sponsored by Rep. Peter DeFazio (D-OR), H.R. 4038 would create an oversight commission that combines certain functions of the Commodity Futures Trading Commission and the Securities Exchange Commission, while also repealing certain provisions of the Commodity Futures Modernization Act of 2000. In the Senate, Dianne Feinstein's (D-CA) S. 1951 seeks to "provide regulatory oversight over energy markets." But experts contend that it would reopen the question of contractual status of some non-exchange traded derivative deals, thereby increasing the legal risk of trades already in place. *[While we were on press, the Feinstein bill was defeated.]*

Quantifying the Issue

Every debate about regulation must consider salient facts and derivatives are no exception. Though available statistics are incomplete at best, they provide a good starting point in trying to solve

the derivative "problem." How big are derivative losses anyhow and do they compare with debt defaults in a meaningful way?

As shown in the table, it depends on how they are measured. In absolute terms, OTC and exchange-traded derivative-related losses of \$156 billion are about 30 percent bigger than debt defaults of \$115 billion. When considering market size, debt defaults are about four times bigger than derivative losses at 0.62 percent versus 0.15 percent. The gap widens if the market size includes exchange-traded activity. Note that the estimated loss rate for both debt and derivatives falls below one percent. Some might cite this loss rate as rather small, especially since no financial transaction is ever completely free of risk.

ESTIMATED LOSSES IN THE DEBT AND DERIVATIVES MARKETS FOR 2001

Market	Dollar Size (\$)	Estimated Losses (\$)	Estimated Default Rate (%)
Debt	18,542.3 billion ^a	115.4 billion ^b	0.62
OTC Derivatives	103.9 trillion ^c	155.6 billion ^d	0.15

Note: The debt information about market size and default experience seems to be for U.S. issuers only. In contrast, the derivatives information considers non-U.S. parties as well. An ideal comparison would examine both debt and over-the-counter derivative markets on a global basis.

a See www.bondmarkets.com/research/lostdbt.shtml for historical, outstanding levels for municipal bonds, U.S. treasury bonds, U.S. corporate bonds, asset-backed securities, federal agency debt, mortgage-related bonds and money market instruments.

b See "Corporate Defaults Hit Record Level Last Year" by Diane Hess, 1/14/02, www.thestreet.com.

c See www.swapsmonitor.com for the "notional size of the global OTC derivatives market" as of June 30, 2000.

d Based on Table 16.5, "Partial List of Organizations Reporting Derivative Losses" from *An Introduction to Derivatives and Risk Management*, 5th edition by Don M. Chance: Harcourt College Publishers, 2001, pages 735-736. Also see "The Wheel of Misfortune" (for LTCM estimated loss), www.erisks.com.

Whether these numbers persist depends on many factors. Increased market volatility raises the stakes in the event that a counterparty defaults, and the quality of a company's system to track and measure risk is a good indicator of future operational problems. Perhaps most important is a top level commitment by senior executives to set proper controls and oversee the use of derivatives by authorized traders.

continued

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OTC Derivatives, continued

Would More Government Regulation Help?

Debating the nature of reform ignores the more fundamental question as to whether mandatory regulation is the right approach in the first place.² OTC trades have long been self-regulated by the derivatives industry and there are some compelling reasons to see that continue. (The reality is that many derivative market participants are financial institutions and therefore are subject to banking or security laws that relate to their use of derivatives.) For one thing, no decree will prevent mishaps that arise from weak management oversight. Consider Metallgesellschaft AG and Barings PLC. Each incident involved exchange-traded derivative instruments that already were regulated and yet large losses occurred. In the case of Metallgesellschaft AG, some specialists say that regulators' actions increased the legal risk associated with "commercial forward contracts."³

Since many legislators are responding specifically to Enron's financial difficulties, it makes sense to ask whether derivatives were misused. School is still out on this point and will be until experts can examine more of the company's records.⁴

Then there is the issue of market response. Did a market panic result from Enron's bankruptcy? Simply put, no. According to Alan Greenspan, "the market's reaction to the

revelations about Enron provides encouragement that the force of market discipline can be counted on over time to foster much greater transparency, and increased clarity and completeness in the accounting treatment of derivatives."⁵

What Now?

Mandatory regulation comes with a hefty price tag. Compliance diverts resources that could be expended elsewhere on behalf of shareholders. The law of unintended consequences looms large and the "one-size-fits-all" approach encourages adverse selection.⁶ This, in turn, rewards imprudent risk-taking and exacerbates problems associated with misuse.

A better approach is for industry leaders to take charge, encouraging transparency with respect to derivative usage reporting, along with promoting risk management education. Senior executives must ensure that risk is well understood by every individual involved in the use of derivatives, starting with the company's leadership team. Ignorance is not bliss and jeopardizes shareholders' wealth by making a company vulnerable to litigation should a derivative loss occur. Derivatives can provide a company with flexibility and cost-savings, but only if used properly. Inevitably, even with more regulation, losses will still occur. But continued vigilance on the part of management and industry advocates can go a long way in minimizing the likelihood of improper use of derivatives. ●

Endnotes

- 1 See www.isda.org for historical dollar OTC outstanding amounts used to generate an average annual growth rate of approximately 40 percent per year.
- 2 The costs and benefits of mandatory derivatives regulation are spelled out in the author's "In Defense of a Free Financial Derivatives Market," 1994. Also see James T. Moser. "A Social Accounting of the Cost and Benefits of Derivatives," www.fenews.com/1998/Issue3/029805.htm. February 1998.
- 3 Kuprianov, Anatoli. "Derivative Debacles: Case Studies of Large Losses in Derivatives Markets," *Derivatives Handbook: Risk Management and Control*. Edited by Robert J. Schwartz and Clifford W. Smith, Jr. John Wiley & Sons, Inc: 1997, page 625.
- 4 Clark, Andrew. "Derivatives at Root of Enron Collapse, Expert Says," www.biz.yahoo.com. January 24, 2002. And Nilly Essaides. "Post-Enron, There's Nothing Wrong With Derivatives Accounting," www.fas133.com. February 28, 2002.
- 5 "Testimony of Chairman Alan Greenspan, Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate." March 7, 2002. <http://stabenow.senate.gov/infocus/030702greenspan.htm>.
- 6 Landsburg, Steven E. *The Armchair Economist: Economics and Everyday Life*. The Free Press: 1993, pps. 3-9.

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