

“No failures, no closures, no taxpayer rescues”

By William Brodsky

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As G20 leaders prepare to meet one year after Lehman Brothers collapsed and other Wall Street giants teetered, there is a collective sense that we have weathered the worst financial storm since the Great Depression and survived, more or less, intact. We must not fool ourselves: other threats are on the horizon. Armed with the facts – and political will – we have the ability to avert the next disaster, but we must act now, while the winds have calmed, but before the remaining debris is cleared and forgotten.

It is uncertain whether policymakers will summon the political will necessary for meaningful change, but the facts, at least, are clear: Unregulated derivatives may not have started the meltdown, but they acted as a powerful accelerant to the subprime crisis and were a major contributor to the collapse of Lehman and the forced rescue of AIG. The failure of regulatory and governing bodies to keep pace with the rapid growth of the massive and complex over-the-counter (OTC) derivatives market set the stage for a rapid, cross-border contagion.

Derivatives represent the largest single segment of the world’s financial markets. Thanks in part to a strong banking lobby, more and more assets now trade OTC. With €471 trillion in notional value in December 2008, the global derivatives market is more than five times larger than the global equities and bond markets combined. Of all derivatives trading, less than 10 per cent takes place on regulated exchanges; the rest trade in largely unregulated OTC markets.

Goldman Sachs chief executive Lloyd Blankfein, in describing [the dangerous morphing of the OTC markets](#), said that the banking industry let the growth and complexity in new instruments outstrip the industry’s capacity to manage them. I applaud Blankfein’s candor and assessment, which, notably, includes no reference to regulators: the largest segment of the world’s financial markets was expected, by and large, to keep itself in check.

The lack of OTC regulation in the US is no accident, but rather the result of a hodgepodge of financial regulatory agencies, combined with decisions made by the financial industry, Congress and several presidential administrations. There is plenty of blame to go around, but where do we go from here?

The liquidity in OTC markets depends on banks providing the pricing of assets and on counterparties willing to trade. The crisis revealed the inherent weakness of OTC markets: the value of assets traded became difficult to assess, banks lost confidence in each other, and illiquidity spread. In short, OTC markets around the world stopped functioning.

In contrast, regulated exchanges throughout the crisis continued to provide transparency, price discovery, certainty of execution and protection against counterparty risk through centralised trading and clearing. Certainly values fell, but participants in exchange-traded markets never found the markets closed or assets frozen. Despite credit failures, bank and brokerage meltdowns and unprecedented levels of volatility, exchanges provided liquid and orderly marketplaces – without interruption – and continued to fulfill the essential functions of capital formation and risk management. Regulated exchanges delivered as promised: no failures, no closures, no taxpayer rescues.

In order to minimise systemic risk and create a well-functioning derivatives market, governments must legislate, to the extent possible, trading of OTC derivatives on liquid and organised markets. Exchange traded-derivatives are cleared via centralised clearing agencies, which assures full collateralisation of open positions and guarantees fulfillment of contracts. Centralised trading and clearing should be applied to all standardised, independently priced products. If we are to reduce the impact of potential failures, then those OTC derivatives that cannot – or will not – be standardised should, at minimum, have heightened capital requirements.

To be truly effective, these steps must be initiated and co-ordinated at the international level. The main obstacle to lowering global systemic risk will come from those jurisdictions that will try to attract business by lowering their regulatory requirements. The threat of cross-border regulatory arbitrage is real.

Deutsche Bank is no more “Deutsche” than Bank of America is “America.” Banks today can do business anywhere. US and EU banking regulation must be co-ordinated to minimise the danger of regulatory arbitrage.

The US Treasury and Federal Reserve, with the support of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), must work with the European Commission and central banks, or set up a commission or co-ordinating body to accomplish this. Alternatively, G20 governments could create a common framework that would set similar international standards for market participants and infrastructure providers. To make this happen, the Financial Stability Board could set up a dedicated group to monitor the joint adoption and implementation of a global framework.

While the standardisation of many OTC derivatives is both a feasible and obvious fix, we should not assume that the banks will voluntarily give up a profitable OTC business model. Banks and their lobbyists claim that attempts to limit the risks of OTC derivatives will make hedging too expensive or too difficult, or that OTC products are too complex to be standardised, but nobody benefits by maintaining the status quo of a system that brought us to the brink.

Many of the benefits and safeguards of exchange trading and centralised clearing can be achieved in the OTC market. Certainly, if the state of the art in financial engineering has evolved to creating highly complex products, we must be capable of creating efficient and safe standards to trade them. Governments and regulators have the means to avert the next disaster. Whether they have sufficient political will remains to be seen.

William Brodsky is Chairman and CEO of Chicago Board Options Exchange and Chairman of the World Federation of Exchanges