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Comment

We must overturn the status quo in derivatives

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Following the collapse of Long Term Capital Management more than 10 years ago, a government report called for derivatives market reform. The report, issued by the President's Working Group in April 1999, noted that "market history indicates that even painful lessons recede from memory with time". Sure enough, once the LTCM headlines disappeared, the impetus for reform vanished.

Today we face a similar challenge – to not let time, a rebound in the market or lobbying efforts of derivatives dealers obscure the need to reform the over-the-counter derivatives market.

Derivatives serve a vital purpose in our global economy. They help institutions manage balance-sheet risk and cut the cost of capital, which in turn spurs investment. However, today's bilateral market has created a dangerous web of obligations between financial institutions. A collapse of one entity can render risk unmanageable throughout the financial system, felling other institutions with domino-like speed. Last year this phenomenon forced the government to intervene in the private sector,

critically damaging a fundamental tenet of capitalism – that the uncompromising hand of the market punishes bad decisions.

In August, the Obama administration proposed reforms to the \$600,000bn OTC derivatives market. They were right to focus on central clearing and margin requirements for standardised derivatives. The plan wisely proposes increased risk-based capital or collateral requirements for those banks, dealers and others entering into non-cleared, non-standardised derivatives positions.

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Such reform would untangle the web that led to government intervention and the creation of the untenable paradigm of "too interconnected to fail".

But merchants of the status quo are lobbying to protect their profits. The five biggest bank derivatives dealers in the US held 97 per cent of the more than \$200,000bn in notional derivatives value held by US banks at the end of the second quarter. This translates into billions of dollars in trading

revenue each year – revenue that is generated from the dealers' privileged position as credit intermediaries with implied government guarantees and from a level of opacity not seen in any market of comparable size. These dealers have lobbied regulators to protect their position even though a lack of regulation poses significant risks to the wider economy and to taxpayers.

We must mandate the clearing of standardised derivatives through regulated clearing houses. Central clearing protected the markets for equity-option, gold-future and energy-future derivatives during the meltdown last year. Within days of Lehman's collapse, its centrally cleared futures and OTC interest rate swaps reallocated without loss to counterparties and without disruption in the markets. Compare this to the failure of Lehman's unregulated credit default swaps and non-cleared interest rate swaps, which triggered chaos in the market because these contracts were not centrally cleared.

When Lehman failed, untold trillions of dollars of risk inherent in OTC derivatives became unhedged, creating significant market exposure for counterparties. The collateral posted by these counterparties is now tied up in the Lehman bankruptcy. Trading through clearing houses will break the

"too interconnected to fail" paradigm, reduce the systemic risk inherent in the bilateral OTC marketplace and provide transparency.

Critics of the Obama plan argue it would "stifle innovation" in the derivatives market. But reform will not bar customised products; it will only ensure that the risks generated by such products are properly capitalised or collateralised. Detractors also argue central clearing will raise hedging costs for companies. But as in the equity-option and energy markets over the past two decades, increased price transparency through central clearing enables less frequent users, such as corporations, to enter into trades at better prices, reducing costs.

The derivatives markets failed us last year. It is shameful that the citizens of Main Street were forced to "bail out" Wall Street. Now is the time to preserve the enormous good created by the derivatives market, while eliminating the flawed concept of "too interconnected to fail". Regulators must implement central clearing where appropriate and put the integrity of our capital markets ahead of the profits of a self-interested few.

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