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### In Defense of Derivatives and How to Regulate Them

Rene M. Stulz. *Wall Street Journal*. (Eastern edition). New York, N.Y.: Apr 7, 2009. pg. A.15

#### Abstract (Summary)

In its current annual report, Caterpillar Inc. makes the case for why it relies on derivatives: "Our risk management policy . . . allows for the use of derivative financial instruments to prudently manage foreign currency exchange rate, interest rate, commodity price and Caterpillar stock price exposures." According to data from Greenwich Associates, two-thirds of large companies (those that have sales of more than \$2 billion) use over-the-counter derivatives and more than half of all mid-size companies (those that have sales between \$500 million and \$2 billion) are very active in derivatives markets.

#### Full Text (1240 words)

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The dictionary defines a derivative in the field of chemistry as "a substance that can be made from another substance." Derivatives in finance work on the same principle. But if you read the headlines these days, you might think derivatives were made from arsenic by Wall Street institutions bent on causing financial destruction.

There are two sides to derivatives – one positive and beneficial, one exploitive and negative. Of the latter, the most visible example today comes to us courtesy of the American International Group (AIG) and reveals what happens when a lightly regulated but highly interconnected financial institution ends up positioned in a way that it cannot survive a housing crash and then such a crash occurs.

The other side of derivatives, however, involves the less-publicized but widespread use of these financial instruments in ways that benefit companies. Derivatives have been immensely valuable tools and will be instrumental in providing the liquidity needed to jump-start the economy. Derivatives are used by a vast number of U.S. companies, both small and large, to manage various risks that arise in connection with their businesses.

From the perspective of Main Street companies, derivatives are not just about high finance, quants and politics, but about investing in America's core industries, jobs and economic recovery. Companies find that over-the-counter derivatives are essential to their day-to-day operations. Derivatives help insulate them from risk, which allows them to borrow capital at better prices than they would otherwise. And derivatives are more useful than ever in these days of unusual volatility in financial markets.

For example, not being able to hedge currency risk through the use of a derivative can leave a company exposed to fluctuations in currency markets. Without derivatives companies could see movements in exchange rates turn a profitable export contract into a money-losing agreement.

In its current annual report, Caterpillar Inc. makes the case for why it relies on derivatives: "Our risk management policy . . . allows for the use of derivative financial instruments to prudently manage foreign currency exchange rate, interest rate, commodity price and Caterpillar stock price exposures."

For those unfamiliar with market jargon, credit default swaps, which are most often in the news, are simply financial contracts between two parties. If, for example, you own bonds in a company and are worried that the company will default, you can manage your risk and protect your holdings with a credit default swap. Under it, you would make regular payments to maintain the contract. If the company does not default, you're out-of-pocket the payments. But if the company does default, the swap serves as a form of insurance by giving you the right to exchange the questionable bonds for the principal amount, or to be reimbursed in other ways. There's nothing exotic or complex about these contracts. They can be highly valuable for Main Street firms, because they enable them to protect themselves against the failure of large customers.

However, Main Street firms cannot afford derivatives unless there is a competitive market for them with participants willing to take the opposite position. Restricting access to derivative markets, which is being proposed by some in Congress as well as

by some regulators, would make the costs of derivatives prohibitively expensive and eliminate liquidity.

That derivatives benefit our financial system and our national economy is well established. Twenty-nine of the 30 companies that make up the Dow Jones Industrial Average use derivatives. According to data from Greenwich Associates, two-thirds of large companies (those that have sales of more than \$2 billion) use over-the-counter derivatives and more than half of all mid-size companies (those that have sales between \$500 million and \$2 billion) are very active in derivatives markets. Derivatives are necessary and helpful tools for companies seeking to manage financial risk.

The most important benefit of derivatives is that they allow businesses to hedge risks that otherwise could not be hedged. This does a number of positive things. It transfers risk, allowing firms to guard against being forced into financial distress. It also frees lenders to offer credit on better terms, giving companies access to funds that they can use to keep their doors open, lights on and, even, invest in new technologies, build new plants, or hire new employees.

It's important for regulators not to overreact by pushing for counterproductive new rules. The regulators, after all, were no better at foreseeing the current crisis than the private sector, proving that regulation has obvious limits and cannot replace efforts by financial institutions to devise risk-management approaches that enable them to cope with crises in the financial markets of the 21st century.

At the same time, some sensible regulations are in order. With the interconnectedness of markets today and the systemic problems facing the world's economies, there is a lot that can be done to limit systemic risks. One beneficial step would be for Congress to adopt some version of a systemic-risk regulator that would place every participant in the financial markets that poses a systemic risk, including derivatives traders, under federal regulatory oversight.

Unbelievably, the arm of AIG that dealt with derivative products was not subject to serious scrutiny by a federal agency with relevant experience. A systemic-risk regulator, or markets-stability regulator, should oversee every kind of financial institution that is found to be systemically important, including banks, broker-dealers, insurance companies, hedge funds, private equity funds and others. That regulator should have the authority to ensure that such financial institutions have sufficient capital to reduce the risks they pose to the financial system, to examine parent companies and subsidiaries, and to bring enforcement actions.

Additionally, a clearinghouse for standardized credit default swaps was launched in March, and other competitor clearinghouses are under construction. Clearinghouses clear and settle trades and limit the risk to the larger financial system if any one dealer, like AIG, fails to meet its obligations. A clearinghouse also allows regulators to monitor the exposure firms have to these products, while simultaneously ensuring that each firm posts the necessary collateral to cover its obligations under its trades.

However, clearinghouses should be reserved for established and standardized derivatives, leaving participants in capital markets free to engage in bilateral contracts for derivatives that fulfill specific needs as well as for new products. Further, use of a clearinghouse should not be compulsory, but capital-requirement regulations should recognize that derivatives positions that are not put through a clearinghouse may pose greater systemic risks than those that are.

The subprime mess triggered one of the most destructive financial crises in decades. It's not surprising, then, that the hunt is on for culprits. But derivatives are not the culprit. They had little to do with the rise and collapse of housing prices. Wider availability of housing derivatives would have actually reduced the impact of the collapse of housing prices if homeowners had been able to hedge against possible decreases in home values.

Our businesses need derivatives. Most of us choose to drive cars even though they sometimes crash. But we also insist that cars are made as safe as it makes economic sense for them to be, and that speed limits and other rules of the road are enforced. The same logic should apply to derivatives.

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(See related letters: "Letters to the Editor: Don't Kill the Good Part of the Derivatives Market" -- WSJ April 17, 2009)

Credit: By Rene M. Stulz

### **Indexing (document details)**

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## Warren Buffet on Derivatives

Following are edited excerpts from the Berkshire Hathaway annual report for 2002:

I view derivatives as time bombs, both for the parties that deal in them and the economic system. Basically these instruments call for money to change hands at some future date, with the amount to be determined by one or more reference items, such as interest rates, stock prices, or currency values. For example, if you are either long or short an S&P 500 futures contract, you are a party to a very simple derivatives transaction, with your gain or loss derived from movements in the index. Derivatives contracts are of varying duration, running sometimes to 20 or more years, and their value is often tied to several variables.

Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counter-parties to them. But before a contract is settled, the counter-parties record profits and losses – often huge in amount – in their current earnings statements without so much as a penny changing hands. Reported earnings on derivatives are often wildly overstated. That's because today's earnings are in a significant way based on estimates whose inaccuracy may not be exposed for many years.

The errors usually reflect the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them. Those who trade derivatives are usually paid, in whole or part, on "earnings" calculated by mark-to-market accounting. But often there is no real market, and "mark-to-model" is utilized. This substitution can bring on large-scale mischief. As a general rule, contracts involving multiple reference items and distant settlement dates increase the opportunities for counter-parties to use fanciful assumptions. The two parties to the contract might well use differing models allowing both to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.

I can assure you that the marking errors in the derivatives business have not been symmetrical. Almost invariably, they have favored either the trader who was eyeing a multi-million dollar bonus or the CEO who wanted to report impressive "earnings" (or both). The bonuses were paid, and the CEO profited from his options. Only much later did shareholders learn that the reported earnings were a sham.

Another problem about derivatives is that they can exacerbate trouble that a corporation has run into for completely unrelated reasons. This pile-on effect occurs because many derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counter-parties. Imagine then that a company is downgraded because of general adversity and that its derivatives instantly kick in with

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their requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can then throw the company into a liquidity crisis that may, in some cases, trigger still more downgrades. It all becomes a spiral that can lead to a corporate meltdown.

Derivatives also create a daisy-chain risk that is akin to the risk run by insurers or reinsurers that lay off much of their business with others. In both cases, huge receivables from many counter-parties tend to build up over time. A participant may see himself as prudent, believing his large credit exposures to be diversified and therefore not dangerous. However under certain circumstances, an exogenous event that causes the receivable from Company A to go bad will also affect those from Companies B through Z.

In banking, the recognition of a "linkage" problem was one of the reasons for the formation of the Federal Reserve System. Before the Fed was established, the failure of weak banks would sometimes put sudden and unanticipated liquidity demands on previously-strong banks, causing them to fail in turn. The Fed now insulates the strong from the troubles of the weak. But there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives. In these industries, firms that are fundamentally solid can become troubled simply because of the travails of other firms further down the chain.

Many people argue that derivatives reduce systemic problems, in that participants who can't bear certain risks are able to transfer them to stronger hands. These people believe that derivatives act to stabilize the economy, facilitate trade, and eliminate bumps for individual participants.

On a micro level, what they say is often true. I believe, however, that the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one other. The troubles of one could quickly infect the others.

On top of that, these dealers are owed huge amounts by non-dealer counter-parties. Some of these counter-parties, are linked in ways that could cause them to run into a problem because of a single event, such as the implosion of the telecom industry. Linkage, when it suddenly surfaces, can trigger serious systemic problems.

Indeed, in 1998, the leveraged and derivatives-heavy activities of a single hedge fund, Long-Term Capital Management, caused the Federal Reserve anxieties so severe that it hastily orchestrated a rescue effort. In later Congressional testimony, Fed officials acknowledged that, had they not intervened, the outstanding trades of LTCM – a firm unknown to the general public and employing only a few hundred people – could well have posed a serious threat to the stability of American markets. In other words, the Fed acted because its leaders were fearful of what might have happened to other financial institutions had the LTCM domino toppled. And this affair, though it paralyzed many parts of the fixed-income market for weeks, was far from a worst-case scenario.

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One of the derivatives instruments that LTCM used was total-return swaps, contracts that facilitate 100% leverage in various markets, including stocks. For example, Party A to a contract, usually a bank, puts up all of the money for the purchase of a stock while Party B, without putting up any capital, agrees that at a future date it will receive any gain or pay any loss that the bank realizes.

Total-return swaps of this type make a joke of margin requirements. Beyond that, other types of derivatives severely curtail the ability of regulators to curb leverage and generally get their arms around the risk profiles of banks, insurers and other financial institutions. Similarly, even experienced investors and analysts encounter major problems in analyzing the financial condition of firms that are heavily involved with derivatives contracts.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. In my view, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.