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Derivatives Debate Demands Distinctions

By Natasha Gural, Editor-in-Chief

The debate over regulating over-the-counter derivatives has become over-politicized, paving the way for unintended consequences because policymakers aren't distinguishing between event-oriented and market risk-driven derivatives, Bob Park, president, chief executive officer, director and co-founder of FINCAD, the leading provider of derivatives analytics, tells Markets Media.

“The concept that derivatives go to a central clearinghouse or be exchange traded is an unrealistic and unnecessary objective,” says Park. “The fiasco last year related really solely to CDS. There is a fundamental difference between derivatives that (position) the holder against an event happening, which is more akin to a typhoon or an earthquake, and typical derivatives use, which is more akin to market risk. (The latter) have functioned fine and are not the source of the problem.”

In a White House version of a statement released Sept. 25 by the Group of 20 developing and emerging nations, global leaders cited “sweeping reforms to tackle the root causes of the crisis and transform the system for global financial regulation.”

“We have enhanced and expanded the scope of regulation and oversight, with tougher regulation of over-the-counter (OTC) derivatives, securitization markets, credit rating agencies and hedge funds,” the G20 said.

U.S. lawmakers decided in 2000 to exempt derivatives from government oversight.

In the wake of the credit crisis, President Obama is seeking a sweeping regulatory overhaul of the financial services industry that would move most derivatives to regulated exchanges and clearinghouses, and impose higher capital and margin requirements. Obama said on June 17 that credit swaps and other derivatives “have threatened the entire financial system.”

Securities and Exchange Commission Chairwoman Mary Schapiro and Commodity Futures Trading Commission Chairman Gary Gensler have proposed a dual regulatory structure for derivatives. Primary responsibility for derivatives tied to securities, such as credit default swaps, should go to the SEC, Schapiro said June 22. Other derivatives, including those related to interest rates and commodities, should be regulated by the CFTC, Gensler said at the time.

Chicago Board Options Exchange Chairman Bill Brodsky told a joint meeting of the SEC and CFTC last month that speed and pricing in the $592 trillion OTC derivatives market is being hampered by dueling U.S. regulations that should be consolidated.

“Customers in banks have already voted with their feet,” says Park. “The reason the derivatives market is so large is (because) it's convenient for corporate treasurers...Many buyside organizations don't have the resources or time to create something out of contracts.”

While “bouts of innovation” are rare in exchange traded products, there is “almost constant innovation in OTC markets,” says Park.

“The OTC derivatives market as a whole has met some societal needs globally. It allowed people greater liquidity in emerging markets,” says Park. “It led to tremendous wealth creation in established and emerging markets. It would really hurt innovation if it were shut down entirely.”

Park warns against “onerous” increases in capital requirements.

“There is no reason to mess them up,” he says. “it could be so dangerous” to enforce higher capital requirements. “Customers won't get the customized solutions they have been getting, making it more difficult for buyside firms to (achieve) management objectives.”

Park doesn't oppose regulation altogether, saying a “need for far greater transparency is one place where regulation can help.”

“We are living in dangerous times. There is danger from poorly thought out regulations,” he says. “If regulations can be designed and discussed in a rational, non-political environment, we have as shot at making some genuine improvements.”