THE WAR AGAINST OVER-THE-COUNTER DERIVATIVES

AN ONSLAUGHT OF BANKING REGULATIONS IS DRIVING UP THE COST OF OTC DERIVATIVES TO A PROHIBITIVE LEVEL

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Regulators clamping down is bad news for banks' profits and the economy

Derivatives are useful instruments for managing risk. They allow companies to hedge certain types of financial risk, such as their exposure to foreign exchange rates or commodities prices, in the same way that they might enter into an insurance contract to protect themselves from nonfinancial risks, such as theft or floods. If used in this way, derivatives reduce the risks of economic factors and promote economic stability.

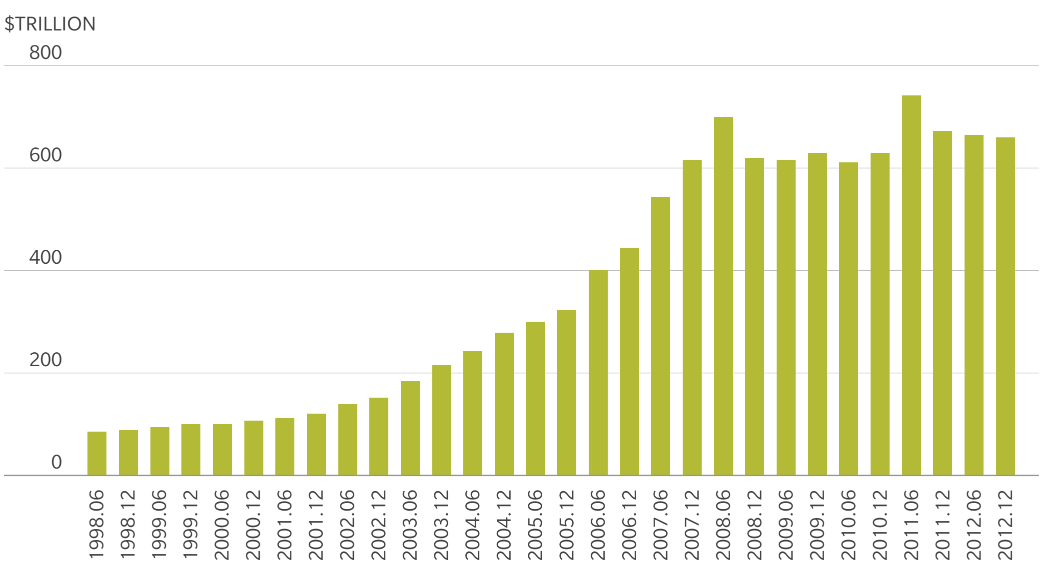
However, the explosion of derivatives usage that occurred at the turn of the century (see Exhibit 1) was not driven only by increased hedging needs. Too often, derivatives were used as a way of gaining exposure to certain risk assets for the sake of speculation – and in many cases, as a way to arbitrage bank capital rules with a view toward improving the banks' return on capital. Rather than mitigating underlying risks, the speculative use of derivatives amplified them.

Following the financial crisis, regulators have been keen to limit the systemic threat posed by derivatives. Their attention has fallen on over-the-counter (OTC) derivatives. Unlike the standardized contracts traded on exchanges, OTC derivatives are bespoke contracts offered mainly by banks and tailored to the needs of bank customers. They often lack the simplicity, liquidity, and transparency of exchange-traded contracts, and potentially allow banks to take on large risks that remain opaque to regulators. And, because many of these contracts are between banks, they increase the potential for contagion during periods of stress, thus increasing systemic risk.

To discourage OTC derivative trading, regulators are driving up its cost. OTC derivatives will attract prohibitive capital costs from new risk-weighted assets requirements plus increased funding costs from new margin requirements.

EXHIBIT 1: THE EXPLOSION IN DERIVATIVES VOLUMES

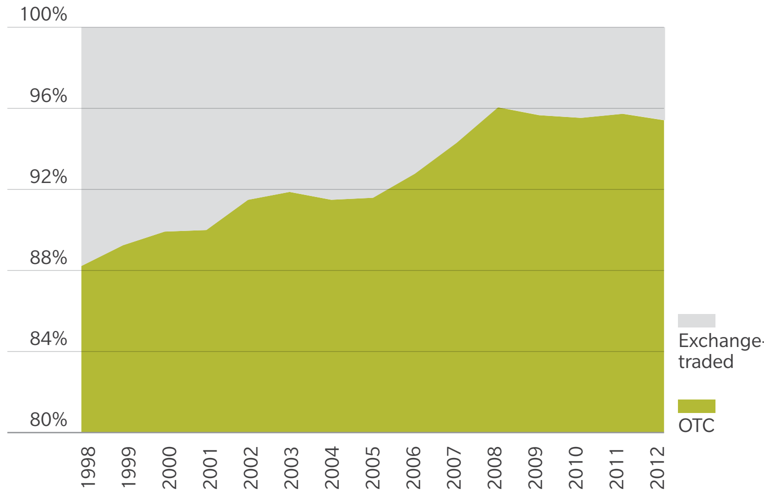
TOTAL DERIVATIVES OUTSTANDING



Source: *BIS Quarterly Review*, June 2013

This increased cost is in part intended to incentivize banks to conduct more of their derivatives activity on exchanges using standardized contracts that are centrally cleared. As can be seen in Exhibit 2, the outstanding amount of OTC derivatives currently dwarfs the exchange-traded market, so there will be major challenges ahead in migrating the OTC volumes to a centrally cleared format. The increased price transparency that comes from standardizing the contracts and moving them onto an exchange will also be a major blow for bank profits. Many bankers fear that regulators won't be happy until they have wiped out OTC derivatives entirely, but we are still a long way from accomplishing that.

EXHIBIT 2: OTC VS. EXCHANGE-TRADED DERIVATIVES



Source: *BIS Quarterly Review*, June 2013

INCREASING SAFETY AT A COST

The regulatory concerns are legitimate, and the new measures will probably lead to a safer banking system. However, there is a risk that if regulators go too far to stamp out OTC derivatives, the increased safety will come at too great a cost.

Banks will attempt to pass on the increased costs of OTC derivatives to their customers. This will either eat into customers' profits or force companies to leave risks unhedged (assuming the standardized solutions using exchange-traded instruments prove inadequate). Limiting a company's ability to manage its risks could lead to it canceling plans to expand or even cause the company to fail. Just as regulations that force banks to reduce their lending activities can lead to reduced economic growth, so might OTC derivatives regulations that limit companies' ability to hedge their risks.

Such protests are likely to fall initially on deaf ears, with regulators assuming them to be driven by the self-interest of banks that rely on these products to enhance their risk-return profile. Support for these products therefore will need to come from the corporate sector.

Politicians will need to hear about the energy project that got canceled because the local energy company couldn't properly manage the risks without the use of OTC derivatives. Investors might also start warning that the increased earnings volatility of companies that can no longer properly hedge their risks makes them less attractive as investment opportunities. Rating agencies might start to downgrade sovereign and municipal governments and municipalities that are also currently big users of the OTC market. All of this will increase the drag on the economy.

However, before such voices are heard, the regulatory pendulum is likely to continue swinging in the direction of stamping out OTC derivatives. That may increase systemic safety. But safety does not come for free.

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