Forwards, not Backwards, with Derivative Market Reform

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My name is John E. Parsons. I am a Senior Lecturer in the Finance Group at the MIT Sloan School of Management and the Head of the MBA Finance Track. I am also the Executive Director of the MIT Center for Energy and Environmental Policy Research. I have a Ph.D. in Economics from Northwestern University. At MIT I teach a course on risk management for non-financial companies, the so-called end-users or commercial hedgers, and I co-author a blog on the subject, bettingthebusiness.com. I have published research on theoretical and applied problems in hedging and risk management, and I have been a consultant to many non-financial companies on hedging problems of various kinds, as well as on other financial issues.

Introduction

Title VII of the Dodd-Frank Act mandates important changes in U.S. derivative markets. Nearly three years since the passage of the Act, many of these changes are not yet fully implemented. Americans remain threatened by the same dangers that exploded on the country in 2008. Congress should consider ways to encourage and enable the full implementation of the Dodd-Frank derivative reforms.

Instead, five of the seven legislative proposals being considered by this Subcommittee and which are the focus of today's hearing take us in the opposite direction.[1] They reverse key elements of the reform. They resurrect the old system in which major segments of the derivatives markets are off-limits to the cop on the beat. They reinstate the old system in which the cop's discretion and authority is severely limited, while at the same time, financial players are given greater license and more loopholes.

It is nearly five years since U.S. taxpayers found themselves trapped and extorted for bailout money by the collapsing dominoes of the financial system. Since then, millions of Americans have been further punished by the enormous damage that the financial crisis wreaked on the job market and business prospects. Few people are confident that the country is completely secure against a new slew of failures that would leave U.S. taxpayers trapped once again. This Subcommittee should not advance legislation that weakens the security of U.S. taxpayers by inviting continued risky behavior by the largest U.S. banks and by a return to the deregulation of derivative markets.

Americans need better. Instead of searching out opportunities to reverse key elements of the financial reform, Congress should first finish the job of making U.S. taxpayers safe and secure. Congress should see the reform through to completion. Derivative regulators need to be resourced to fully implement the Dodd-Frank derivative reform, and encouraged to finish the task. This would assure American citizens that U.S. derivative markets are once again a source of stability and productivity to American and international industry and commerce

Which Business Model for OTC Swaps?

A range of different derivative securities and market designs are needed to serve the range of different demands of American and international businesses. The OTC swaps marketplace is uniquely positioned to offer customized as well as less liquid derivatives, which complement the standardized derivatives offered for trade on futures exchanges. This was the business model when the OTC swaps market first arose at the end of the 1970s. Providing these complementary products is useful, and can be supported by a proper regulatory framework like Title VII of the Dodd-Frank Act. Congress is well

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[1] The five which I characterize as a step backwards are: H.R. 634, the Business Risk Mitigation and Price Stabilization Act of 2013, H.R. 677, the Inter-Affiliate Swap Clarification Act, H.R. 992, the Swaps Regulatory Improvement Act, H.R. 1062, the SEC Regulatory Accountability Act, and, H.R. 1256, the Swap Jurisdiction Certainty Act. The two, which I would not characterize as a step backwards, are H.R. 742, the Swap Data Repository and Clearinghouse Indemnification Correction Act of 2013, and H.R. 1341, the Financial Competitive Act of 2013.

advised to examine and reexamine ways to support and encourage this type of derivative trade which provides a real service to the economy.

Unfortunately, alongside this useful service arose another trade in derivatives fueled primarily by the lack of regulation of the OTC swaps market. This trade valued operating in dark markets and the ability to evade supervision. This trade warehoused growing volumes of credit risk on the balance sheets of derivative dealers. This trade does not complement the risk management services that can be offered on America's regulated futures markets. Growth in this trade during the late 1900s and early 2000s was a classic case of regulatory arbitrage. Unfortunately, over time this arbitrage trade came to dominate the OTC swaps industry and shifted the focus of its business model. This arbitrage trade did not have an interest in sound and stable markets because its very existence relied on a lack of regulation and oversight. This arbitrage trade did not advocate wise regulation: it fought hard for no regulation. This is best epitomized by the legislative fight over the now infamous Commodity Futures Modernization Act of 2000.

When the financial crisis exploded in 2008, it was the unregulated OTC swaps market that contributed to the crisis, not the regulated futures markets. Title VII of the Dodd-Frank Act put an end to the regulatory arbitrage by applying three principles already characteristic of the regulated futures markets:

- universal supervision – all swaps are now subject to supervision by the CFTC and the SEC;
- transparency, and,
- clearing of standardizable products.

If and when it is fully implemented, this reform puts an end to the regulatory arbitrage.[2]

Unfortunately a large portion of the OTC swaps industry remains wedded to the old business model of relying upon legislated loopholes and regulatory exemptions to preserve its share of the market. It constantly turns to Congress in a bid to repeat the success it had before the financial crisis blocking sound and universal standards for market conduct.

[2] As some elements of the reform begin to take effect, we are seeing one consequence of the disappearance of this arbitrage: the futurization of swaps. This is happening through several different channels, which I have discussed in my blog at some length, but which are not central to today's discussion. For example:
http://bettingthebusiness.com/2012/08/01/otc-rip/
http://bettingthebusiness.com/2012/08/10/moodys-slips-on-ice/
http://bettingthebusiness.com/2012/11/13/futurization-2-why/
http://bettingthebusiness.com/2012/12/04/futurization-advances-in-interest-rate-products/

Just as an illustration, let's take the example of clearing. Futures markets in the U.S. have employed universal clearing since the early 20th century. Throughout the 20th century these markets were global leaders in serving the needs of diverse types of businesses in agriculture, metals, energy and all parts of the economy. Once implemented and operating, there was no complaint from business that clearing was an obstacle to these markets. On the contrary, every textbook or industry manual described clearing as an essential element of the success of these markets. But the arbitrage trade in the OTC swaps market evolved without the same rigorous standards for clearing. It benefited from and relied upon the regulatory arbitrage this enabled. Although the Dodd-Frank Act requires that clearing be extended to the OTC swaps marketplace, the arbitrage trade continues to see special exemptions and loopholes as the key to its success. Instead of providing a better derivative product or service, the arbitrage trade requires weakened market supervision and lowered standards in order to maintain its market share.

Much of the legislation at hand in today's hearing supports the bad business model of the OTC swaps industry's arbitrage trade. That model based on legislative favor and protection from supervision. The legislation is animated by the private benefits of loopholes for select constituencies, and overlooks the value of universal standard and sound financial markets that benefit the U.S. economy.

What the country needs is an OTC swaps industry focused on serving the real financial needs of American business. What the country needs is good regulation that supports sound and stable derivatives markets providing real services to America's businesses. What the country needs is to finish the implementation of the Dodd-Frank derivative markets reform. As of today, the job is not yet done, and that is where Congress should focus its attention.

Cost/Benefit Analysis

I'd like to conclude with some personal reflections specific to H.R. 1062, the Swaps Regulatory Accountability Act, which purports to improve the SEC's consideration of the costs and benefits of regulations.

I am an advocate of good cost/benefit analysis. It is a core element of my identity as a finance professional. I am affiliated with a university that has a reputation for quantification. I am the Executive Director of a research center with the mission to promote rigorous and objective empirical research to support decision-making by government and industry. I have played an active role in analyzing the costs

and benefits of the Dodd-Frank Act's derivative reform. Just recently, a study I did which addresses the cost of certain provisions of the Dodd-Frank Act's derivative reform was published in Morgan Stanley's *Journal of Applied Corporate Finance*.[3] I had presented earlier versions of the study to regulators and legislators. Some of my colleagues, working within the government, have been strong advocates for more widespread attention to rigorous cost/benefit analysis, and I support their efforts. So I am at one with the stated intention of this legislation.

However, I do not believe the legislation truly advances sound cost/benefit analysis. Instead, it undermines it. I have seen up close how seemingly well intentioned mandates such as this can actually undermine honest cost/benefit analysis and the democratic process. Many so-called 'studies' already get produced for the sole purpose of influencing the regulatory process. Already, existing legal mandates generate many studies custom tailored by well paid lobbyists to fit the terms of those mandates. These studies, animated as they are by private interests and strategic maneuvering, often miss the real points that ought to inform the public debate on costs and benefits. They always have a top line number prepared for headlines and legal briefs. But underneath the analysis is shoddy, at best, and literally non-existent in some cases. In other realms of finance where analogous mandates exist, the same distortion of the process occurs. Business people familiar with the poor quality of "fairness opinions" used in mergers and acquisitions will understand what I am talking about.

Sorting out the good analysis from the bad is a long and arduous process. The United States has a proud history of openness in rulemaking, complemented by vigorous public debate and an energetic press corps. Ultimately, it is the democratic process that assures that the good analysis wins out more often than not. That democratic process cannot be short cutted by mandates like the ones embodied in this legislation, but it can be damaged by them. I have personally witnessed strategy sessions in which players cynically worked to exploit existing cost/benefit mandates in order to frustrate the rulemaking process, and not to shed more light on the critical issues. That, too, is a part of the democratic process, for good or for ill. We should not be naïve as we attempt to improve the quality of information in the regulatory process.

As a professional deeply involved in advocating higher quality cost/benefit analysis in public policy formation, I am afraid that I see H.R. 1062 as a step backwards.

[3] Mello, Antonio S., and John E. Parsons, 2013, Margins, Liquidity and the Cost of Hedging, Journal of Applied Corporate Finance 25(1). http://onlinelibrary.wiley.com/doi/10.1111/jacf.2013.25.issue-1/issuetoc