Chapter 7
Regulating Global Derivatives

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Derivatives are as old as commerce and finance themselves. The first derivative contract can be dated back to ancient Mesopotamia, while options contracts are quoted in the Bible (Swan 1999). Derivatives contracts are tailored on customers' needs and represent the natural evolution of financial markets, where players are looking for new profitable opportunities and better resource allocation (Greenspan 2000). Exchange-traded derivatives (futures and options contracts) in December 2007 reached a turnover of US$2,289 trillion (Bank for International Settlements [BIS] 2008); over-the-counter (OTC) contracts involve US$595 trillion (notional amount outstanding), corresponding to US$15 trillion of gross market value in the same period. These resources represent approximately 11 times the global gross domestic product (GDP). The strength of derivatives lies in their liquidity and marketability, and also in their ability to circumvent regulation from national or international bodies. A number of challenges must therefore be addressed in the global financial architecture in order to guarantee safety and stability, restore confidence and avoid further crisis. The most significant problems posed by derivatives are the lack of homogeneous rules and accounting standards in the presence of common purposes by investors (i.e., profit seeking); the excessive freedom allowed to market players (i.e., financial deregulation), especially to sovereign states; and the lack of complete statistics for exchange-traded and OTC transactions. As the recent turmoil and bankrupts testify, the present risk-monitoring and compensation systems are unable to cope with the effects of derivatives and urgently need to be revised.[1]

The subprime crisis started in 2007, and the resulting economic slowdown of 2008–09 substantially contributed to the negative role played by moral hazard in non-regulated financial transactions, such as OTC financial derivatives (e.g., credit derivatives). Such transactions have been widely employed to shift credit risks, in the absence of a proper compensating system.[2]

The circumvention of rules has partially diminished since 2007 with the introduction of the Basel II Capital Accord, which affects the portfolio choices of banks, and of the International Accounting Standard (IAS) 39, which influences also the non-financial sector. However, Basel II is not applied by American financial domestic operators, and this imbalance substantially modifies the structure of the banking system. The bankruptcy of the American investment bank Lehman Brothers is probably the final result of this gap, while the losses of the European banks Northern Rock and Société Général were detected in time to rescue depositors and reduce the damage.

In the present system there is a substantial difference in risk management and a gap among European and American financial institutions. From the point of view of European financial institutions, the application of the IAS and Basel II rules came with a

[1] Alan Greenspan stepped down as chair of the United States Federal Reserve System in December 2005; in 2008, he agreed that the deregulation allowed by the Fed contributed to excessive risk-taking behaviour and indirectly to the financial crisis.

[2] The current financial crisis is rooted in the uncontrolled and unmonitored use of credit derivatives to shift the credit risk of the subprime mortgages (see, for example, Krugman 2007).

burden of operational costs, in addition to heavier capital requirements, which distorted competition and productivity in the global financial system. The application of homogeneous rules in the global financial system would help restore market credibility and indirectly revive the inter-bank market, which has been squeezed since the last year and a half. The cost of more expensive accounting, capital and prudential rules more than counterbalances direct and indirect gains.[3]

As a first step toward strengthening markets, complete data on OTC transactions should be available more frequently to all market players, to abolish the deregulation and excessive freedom allowed to financial intermediaries in the recent past (Greenspan 2000).[4] The lack of such restrictions was first underlined by the U.S. Federal Reserve, which nonetheless did not push for the necessary modification of rules and regulations.

The quality of data is relevant to improving transparency and positively influencing market confidence; the market measurement of derivatives (for exchange-traded and OTC contracts) can no longer rely on notional amounts outstanding, because they are never exchanged between the parties (BIS 2008). Statistics should instead provide details on turnover, market value, counterparty risk, open interest and margins, and exchange tradability; if the transaction is OTC, the collateralization should fully satisfy Basel II risk-weighting requirements. Today the Bank for International Settlements is the only institution in charge of collecting statistics on OTC derivatives; the BIS can actively work to implement statistics and information, and can co-ordinate effectively with the IMF.

With respect to market players, special non-financial institutions such as (highly indebted) governments should not be allowed complete freedom in OTC derivatives. The main danger is the absence of any control on effective risks, with respect both to counterparties involved in the financial transactions and to the effects of these transactions on future budgets. Governments and the public sector are not compelled to satisfy any accounting and prudential principles or respect any capital requirements (General Accounting Standards Board 2006, 2007). Indeed, they can modify their risk allocation with no special requirement. This opacity introduces an extra risk in the financial system, which can have a negative impact on the financial stability in periods of economic slowdown, when public deficits usually worsen.

The freedom of governments in financial markets can upset the budget equilibrium, and transform it into a political risk, for example, with regard to the length of mandate (see Oldani 2008, Section III). A limited number of public institutions have declared bankruptcy because of financial mismanagement (such as Orange County in the United States and the city of Taranto in Italy), but over the last ten years most developed countries have engaged in interest rate swaps and credit default swaps at the central and local levels, to manage their (increasing) deficits and debts. These transactions are not reported properly, and counterparty risk is not hedged.[5]

[3] The International Accounting Standards Board (IASB), the BIS and the European Central Bank (ECB) have studied in depth the impacts and costs of the new set of rules.

[4] The only source of data on OTC derivatives is the Triennial Central Bank survey co-ordinated by the BIS; on the contrary, exchange-traded data are available daily.

[5] An example is the city of Milan, which has potential losses of €250 million on swaps, due to counterparty risk originating in the collapse of Lehman Brothers, as estimated by the Italian Public Accounting Court (Corte dei Conti).

The accounting of derivatives is a controversial issue, and requires more transparent and comprehensive information on the risks taken by banks, firms and the public sector. Diminished secrecy will reduce the profits of any intermediaries, but it can strengthen the market and restore credibility.

Regardless of finance theory, the subprime crisis underlines the fallability of markets and institutions (Oldani, Masera and Savona 2008). Action is urgently needed because financial deregulation is not compatible with financial markets that are far from being efficient and perfect.

Financial deregulation should not go further, since it proved to be unable to guarantee stability. The revision of the IMF's mission should pursue global financial stability, considering un-perfect markets and irrational agents; freedom allowed to governments in OTC transactions should be terminated. The IMF should be able to facilitate and supervise the global financial system and should use tools such as more comprehensive (market-based) global regulation, proper standard settlements and deeper statistical disclosure. This approach is far from the Washington consensus of old, and should come with a new global governance rule, freeing the IMF from negative political influences and pushing for the reform of the present financial architecture.

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