

Derivatives

Damoclean days

NEW YORK

Huge risks remain in derivatives. There are ways to reduce them

OF ALL the newfangled financial creations that have caused problems this past year, arguably the most nerve-wracking are derivatives traded over-the-counter (OTC), or in private deals away from exchanges. The concerns are twofold: that the huge growth of these instruments has put the supporting infrastructure under strain, and that the failure of a big trader, or "counterparty", to honour its commitments could cause chaos. Bear Stearns's entanglement in credit-default swaps (CDSs) was the prime reason why regulators dared not countenance the Wall Street firm's bankruptcy in March. With corporate defaults on the rise, the prospect of widespread counterparty woes "overhangs the market like a Damocles sword that is bound to fall", George Soros, an outspoken investor, has opined.

Efforts to prevent catastrophe date back to 2005, when the Federal Reserve Bank of New York first banged dealers' heads together over sloppy trade processing. The Bear Stearns debacle, and the expansion of the CDS market to more than \$62 trillion in notional value, gave extra importance to making the system more resilient. Adding to the sense of urgency are the strains felt by bond insurers who had written CDS contracts for banks hoping to hedge their mortgage risks.

The biggest push yet to strengthen the market came on July 31st, when, at the Fed's urging, major dealers set out ambitious goals to cut trading and settlement risks, mostly over the next six months. There was further acknowledgment of the need for change a few days later, with publication of a report by a group of senior bankers led by Gerald Corrigan, former head of the New York Fed.

Much progress has already been made. The backlog in trade confirmations, which spiked alarmingly last summer, has since been cut sharply; roughly half of all deals are now confirmed on the day they are made. The share of CDS trades conducted electronically, around 50% in 2005, is now above 90%. The dealers' group has pledged to extend the work done in tidying up credit and equity derivatives to commodity, foreign-exchange and interest-rate contracts. Only half of all OTC interest-rate trades are automated.

Other areas of focus include trade settlement and "novation" (when one party replaces another as buyer or seller of protection). The dealers have promised to

Bank losses

Hall of shame

Many bank bosses should count themselves lucky still to be in a job

BANKING sells itself as a cut-throat industry, lavish in its rewards but steadfast in its treatment of underperformers. A year into the credit crisis, it has too often been steadfast in its rewards and lavish in its approach to failure.

The three banks that have suffered the heaviest losses since credit first crunched—Citigroup, Merrill Lynch and UBS—have all swept out the old management since their problems surfaced. But of the ten banks to have spilt the most red ink over the past year (see table), five have the same chief executives in place.

Some can muster decent arguments for continuity. HSBC, which reported its first-half results on August 4th, has taken heavy losses but is strongly capitalised and well diversified; its shares have been a rare haven for bank investors. Bank of America can justifiably claim to have stood back from the worst excesses of America's mortgage-lending boom.

Other bosses have fewer hiding places. Royal Bank of Scotland, which was expected to unveil further losses on August 8th, finalised the costly acquisition of ABN AMRO, a Dutch bank, after the crunch had started. Its boss, Sir Fred Goodwin, is widely thought to be living on borrowed time. Washington Mutual, a Seattle-based thrift, has suffered the largest share-price decline of the ten. Kerry Killinger did enough damage to lose his role as chairman in June but not,

apparently, enough to lose his position as chief executive. John Mack retains both roles at Morgan Stanley despite some sloppy risk management.

Stories of survival spread far beyond the top ten. It appears particularly hard to get the sack from British banks. The bosses of Fannie Mae and Freddie Mac, America's limping mortgage giants, continue to draw handsome salaries. Firing people does not guarantee success: signs of impatience with new brooms like John Thain at Merrill are now visible. But it ought to be the price of failure.

Loss leaders

Performance since August 9th 2007

	Write-downs and losses, \$bn	Fate of CEO	% fall in share price
Citigroup	54.6	Replaced	-58
Merrill Lynch	51.8	Replaced	-62
UBS	38.2	Replaced*	-63
HSBC	27.4	Survived	-6
Wachovia	22.0	Replaced	-61
Bank of America	21.2	Survived	-31
IKB	15.9	Replaced	-83
Royal Bank of Scotland	15.2†	Survived	-53
Washington Mutual	14.8	Survived	-86
Morgan Stanley	14.4	Survived	-30

Sources: Bloomberg; Thomson Datastream; company reports *July 2007 †Before first-half 2008 results

"hard-wire" cash settlement, rather than physical delivery of bonds, into standard documentation. Physical delivery could distort prices as defaults rise, because the value of CDS positions far exceeds the face value of the corporate debt they refer to. Novation is no less thorny. Buyers and sellers need to know promptly when the party on the other side of the trade changes, but they are being swamped, some with thousands of novation requests a day. There is new technology to solve this, from firms such as T-Zero. But progress is patchy.

Most eyes, however, are on the promise by 17 large dealers to launch a clearinghouse for credit derivatives by the end of this year. As with an exchange-based clearer, this would act as a central counterparty, backed by a default fund, and thus greatly reduce the risk of any one player's failure destabilising the system. And, by "netting" the trades it handles, the clearer could dramatically reduce the overall value of outstanding contracts.

This is primarily a response to regula-

tory pressure. But dealers have also become worried about the counterparty risks posed by their peers. By turning their market into a hybrid—centrally cleared but still privately negotiated—they hope to make it more robust while safeguarding the fat spreads they earn by hawking OTC products. Exchanges, such as Chicago's CME, are vying for a share of the market.

Many contracts will inevitably gravitate towards exchanges: index-based CDSs are becoming increasingly standardised. But demand for customised contracts is likely to remain heavy because many like the anonymity, points out Darrell Duffie of Stanford University. All the more reason to find ways, quickly, to blunt that sword. ■

Correction: In our article on Meindl Bank last week ("Pulling the wool") we said that Julius Meindl was the head of the Meindl family. He is not. He is head of the financial-services arm of the family business. Sorry.

Clarification: In the same issue, the company with which Merrill Lynch recently settled a hedging dispute ("Thain takes the pain") is XL Capital Assurance, not XL Capital Ltd.