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VIEWS FROM BEYOND THE BARRON'S STAFF

In Defense of Derivatives

They're necessities, not dangers, argues a longtime proponent

BY LEO MELAMED • In the last half of this century, science has moved from the big to the little, from the vast to the infinitesimal. From general relativity to quantum physics, from individual cells to genes. The advances in financial markets have been strikingly similar, but much faster. We are now in the Age of Derivatives, financial equivalents of particle physics and molecular biology. We have moved from long-term hedging to on-line risk management; from macro to micro.

The new era dawned in the early 'Seventies, when the Chicago Mercantile Exchange launched the International Monetary Market to develop trading in financial futures. Thereafter, evolutionary forces in finance, technology, global markets and world economies transformed these simple tools into complex derivatives that can deal with the fundamental components of financial risk.

Derivatives secure their values from other assets, such as stocks, bonds, currencies or commodities. Simple futures contracts in foreign exchange, Eurodollars and bonds have become swaps and swaptions, strips and straps, collars and floors. Investment evolution is the offspring of necessity.

We live in a highly hazardous economic environment, in which competition is global, volatility is constant and opportunities rapidly appear and disappear. Derivatives reduce risk and boost profits. They enhance the efficiency of businesses, benefit bank depositors and borrowers, improve portfolio managers' performance and help farmers, mortgage lenders and commercial users of energy. Derivatives have fostered rapid growth in international trade and capital flows, allowing excess savings in mature industrialized countries, for example, to be funneled into higher-yielding opportunities in developing nations.

It should be noted that there are two types of derivatives: privately traded over-the-counter instruments that circulate among banks and their large corporate and institutional customers, and exchange-traded ones – financial and commodity futures and options. Combined, these two sectors add up to a multitrillion-dollar market.

While the OTC derivatives market is the larger, it lacks the exchanges' protective components, such as daily mark-to-market value adjustments, required margin deposits, price and position limits and, most notably, the guarantee of a central clearinghouse. OTC products also lack strict regulatory oversight.

A Warning From Kaufman

Clearly, there are both bulls and bears on derivatives. Many argue that derivatives endanger the world's financial fabric. Economist Henry Kaufman, while fully acknowledging their benefits, has warned: "The high market volatility of our new financial world and the potential for even higher volatility given the broad range of instruments available to participants contain the seeds of potentially adverse consequences for investment, for credit creation and ultimately for monetary policy."

Unquestionably, whatever the exposure, it is off-balance sheet, potentially volatile and difficult to assess. And the sums involved are enormous. Regulations for strict accounting procedures and reserve requirements are necessary.

As of year-end 1991, a Commodities Futures Trading Commission study reports, there were 20 U.S. swap dealers with notional principal exceeding $10 billion. And the Securities and Exchange Commission indicates that aggregate notional principal held by major U.S. broker-dealer affiliates on interest-rate and currency swaps and foreign-exchange forward contracts roughly equaled the aggregate value of these dealers' futures positions.

A few large end-users account for much of total industry activity. According to *Barron's*, the inner circle includes Bankers Trust, Citicorp, J.P. Morgan, Chemical Bank, Chase Manhattan, Swiss Bank Corp., Deutsche Bank, Societe Generale, Merrill Lynch, Goldman Sachs and Salomon Brothers. From there, the exposure circles widen dramatically.

There are few, if any, known loan-loss reserves within this off-balance sheet market. Consequently, who is on the other side of the risk is a very important question. Nevertheless, the CFTC study concluded that "no fundamental changes in regulatory structure appear to be needed at this time." Similarly, a recent analysis by the Group of Thirty, a private-sector task force headed by former Fed Chairman Paul Volcker, concluded that derivatives don't add to the risk that already exists in today's financial environment.

That isn't to say, however, that the global financial system isn't vulnerable to a major shock from wars, political upheaval, economic dislocations, natural disasters, etc. Quite the contrary. At today's market levels, such vulnerabilities are magnified.

A Liquidity-Driven Bull

Also, it's important to realize that the current world bull market in financial assets is highly dependent on liquidity. Should liquidity diminish, these assets would be significantly exposed. And derivatives add liquidity.

Kaufman has noted that derivatives evolved following the dramatic rise in "floating-rate financing opportunities; massive securitization of mortgages and other financial products; sweeping internationalization of trading of currencies, bonds and equities; a striking shift toward institutionalization of portfolio investment; and a worldwide explosion of budgetary deficits, and the associated mushrooming of so-called risk-free government bonds . . ."

These trends aren't about to change.

Indeed, we're poised for another quantum technological leap, via "artificial intelligence," a phrase that embraces such trading innovations as neural networks, fractals and chaos theory. Many major American brokerage firms already have quietly spent hundreds of millions, perhaps billions, to develop this technology.

The fears voiced about the risks in derivatives echo those generated about genetic engineering. And just as Congress has found it impossible to fully direct the development of genetic research, it will find it is impossible to stop financial engineering. In a global market, the ingenuity of physicists, biologists and financial market participants will continue unabated. And so will the Age of Derivatives. ■

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