

Testimony of Eugene H. Rotberg
Before the
U. S. House of Representatives
Committee on Banking, Finance and Urban Affairs
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My name is Gene Rotberg. Let me first express my appreciation for being asked to testify with respect to matters dealing with the derivatives markets. I ask to be incorporated into this record remarks I gave recently to the National Association of Corporate Treasurers entitled, "The Only Perfect Hedge is in a Japanese Garden."

A lot has already been written and reported about derivatives: a minority staff report from this committee, Congressional hearings, a GAO study, a Group of Thirty report, a Federal Reserve report and commentaries by virtually every accounting, banking and securities association. There have been press reports of losses by dealers and corporations, lawsuits, investigations and attention by every relevant regulatory agency. For purposes here, let me try to focus on why the subject matter has and will likely cause a great deal of continuing stress. I believe it is a peculiar combination of five unique and potentially dangerous circumstances.

First, derivatives can be used to leverage risk -- interest rate, currency rate, share prices -- without putting up a lot of money. That simply means that during a period of volatility, losses or gains are magnified manyfold. And often the leverage is asymmetrical; that is, the potential gains are limited, while the losses may be multiples of the maximum gain.

Second, current accounting conventions mask error, risk and mistake. They are not designed as risk management tools. They have tax consequences, which may be one of the reasons why it has been so difficult to develop a comprehensive set of conventions which also can be used for risk management purposes.

The truth is we do not, generally, mark derivatives to market. Many derivatives are unmarkable. In certain transactions, mistakes can be hidden because accounting conventions do not record them, either because they are ad hoc or there is no market, or they are off balance sheet. There is, too often, little reality testing. We continue to pretend that a rolling loan gathers no loss. We pretend that if a triggering event occurs in a different time period, the loss

EUGENE H. ROTBERG served for 11 years at the SEC as Associate Director for Trading and Markets and a member of the Special Study of Securities Markets. Thereafter, for 19 years, he served as Vice President and Treasurer of the World Bank, responsible for the financing of that institution and the investments of its liquid assets. From 1987 to 1990, he was Executive Vice President of Merrill Lynch & Co., Inc., with responsibility to devise a system for monitoring, controlling and managing the market risks to which the firm was subject in the fixed income and currency markets. Mr. Rotberg now advises governments, international institutions and financial institutions on matters dealing with interest rate and exchange rate volatility, the development of capital markets, investment in emerging country markets, and overall financial policy.

can be delayed. And when losses can be ignored, greater risks are taken. The latest FASB proposed draft on derivative accounting is a beginning, but the draft is deficient because it will not, yet, put the users under the pressure involuntarily of admitting to failure, risk and error. I think the response to the latest FASB draft will illustrate the point.

Third, senior managers are rarely as informed as traders, and legislation is not likely to make them so. Typically, senior management is usually unaware of the technical operations of financial engineering. Worse, they are often afraid to ask, out of concern of admitting to their lack of mastery over the subject matters, and I think we also must admit to the fact that there is a good deal of underlying hostility to financial superstars, mathematicians, physicists. Senior management often believe the financial engineers are too young; too overpaid; they have too much control; they are too smart; they know what to hide and, too often, how to hide what they are doing and why they are doing it. Management is not trained in the intricacies of convexity or volatility. As a result, reports are inadequate, supervision thin. Risk management leaves a lot to be desired. Worse, most of us have great difficulty in admitting to those who report to us that we do not know nearly as much as they. That is a recipe for potential disaster. The good news is that senior management is becoming aware of what they don't know. In the Group of Thirty study recently completed, 57% of senior managers had serious or some concern over their risk management systems; 71% over the complexity of their derivative products; 89% over the illiquidity of certain products. On the other hand, for multinational corporations, the correct timing of a move in the foreign exchange markets can do wonders for a fall-off in sales.

Fourth, many products, particularly over-the-counter derivatives and aspects of the mortgaged-backed market are idiosyncratic, ad hoc, unpublicized, illiquid. That means they are difficult, if not impossible, to price or value. It means that if held as collateral, there may be no buyers in the event of a forced sale, or the spreads between buyers and sellers may be so wide that even hedges are ineffective. That means that a bank dealer which holds such instruments may have to sell short instead, say, plain vanilla U.S. Government bonds in very large amounts to protect itself. That complicates the Federal Reserve responsibilities.

Fifth, the relationship between the banker and the other side is typically unclear, at best, and possibly adversarial. Is the other side of the bank dealer a client, or a customer, or a beneficiary, or an adversary. What is the responsibility and practice to provide stress modelling scenarios to the "other side." Is the banker hedged or is he betting the opposite way from the end user. Whatever the obligation of disclosure, it is clear the end user rarely asks. It should.

Eight years ago, in a speech entitled, "Be on Guard in the Glittery World of Financial Innovation," I wrote:

"Many new instruments have developed because of peer pressure; they are poorly priced with little academic or market rationale. Most innovations have uncertain economic benefit -- they typically involve a sharing of unknown risks for unknown benefit at a price which is simply market clearing. There also is a bit of the "herd" instinct -- by intermediaries, issuers and investors. There is competitive pressure to simply execute the latest instrument for a client or to create the next one, whether or not it

makes sense, simply because it is market clearing at a cost which appears low compared to some other benchmark...

Senior managers and their regulators will find it a challenge -- to say the least -- to find out what is going on and whether it makes sense. But unfortunately, I suspect, wisdom ex post will likely be measured by an accounting convention."

Little has changed.

Sigmund Freud would have been a wonderful witness here. He would have explained the use of derivatives as denial and rationalization -- the pretense that we are doing one thing when we really mean to do something else; the relationship between the banker and its client as one of ambivalence and reliance on the father figure; the use of accounting conventions as repression and the absence of reality testing; the work environment as the pleasure/pain principle -- current pleasure for future damage, let someone else pick up the pieces; leveraging and doubling our bets as counterphobic behavior; termination therapy as what happens when the CFO and Treasurer get caught; and of course, transference -- how the trader seeks to shift responsibility to his or her superior when the string runs out.

Three years ago, in Senate hearings on the operations of the government securities market in connection with the Salomon Brothers affair, I testified:

"Finally, I would urge a major inquiry -- not an adversarial investigation -- into the operations of the securities markets (including the government securities markets and those of derivative products and financing) similar to the Special Study of Securities Markets conducted in the early 1960s which reported directly to Congress."

I can only repeat the same recommendation here, but this time note, merely by way of example, five matters, almost chosen at random, which have not yet really been publicized, and which are indicative of what we don't know about -- except in the most superficial and uncoordinated fashion.

1.U.S. federal agencies issue structured finance paper in which the agency obtains a lower cost than a "straight vanilla" issue, but somewhere down the line, after the agency has hedged its risk, a small, rather unsophisticated S&L or a pension fund (the buyer of the paper), in return for a pick-up in yield, may end up with a zero return over time if yields rise because of an imbedded option (whose value is very difficult to quantify) which works to the buyer's disadvantage. What is the issuer's responsibility? The banker's who sold it? What is the instrument's liquidity? S&Ls will, yet again, be at risk. While there is no real credit risk (these are AAA issuers and exempt securities), there is a lot of asymmetrical leveraged market risk taken by institutions whose deposits are guaranteed by federal authority, but who are putting not credit sensitive paper on their books, but complex and illiquid products whose value will sharply erode in response to changes in interest rates.

2. The effects of illiquid collateral, particularly in the mortgaged-backed market, and its effect on the U.S. government bond market when small changes in interest rates are magnified when the collateral can't be sold and, instead, the U.S. government bond market absorbs the selling pressure as financial intermediaries seek to protect themselves.
3. Equity swap positions of banks. To what extent are banks, through the use of derivative products, taking substantial positions in the stock markets domestically and/or in foreign stock markets with the explicit currency risk?
4. The practice and implications of end-of-month or quarterly cleaning up of derivative portfolios in order to avoid disclosure.
5. The use of derivatives in the FOREX market and its implications for public policy, government intervention and the maintenance of stable exchange rates.

These matters get too close to the edge of propriety or legality to expect voluntary disclosure to form letters.

Does this all mean that there is great systemic risk? No. Or that major banks or corporations are likely to tumble in a domino effect? No. Will some be badly hurt? Yes. Are some S&Ls, securities dealers and corporations taking imprudent risks? Yes. It means mostly, though, that regulators are not up to date because they do not have up-to-date quality information about what is really going on in the market -- and when they do get it, it is after the fact, ad hoc, in a criminal investigatory setting, which rarely predicts the next financial crisis.

Thank you.