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

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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, transferrence -- how the trader seeks to shift responsibility to his or her superior when the string runs out.

With respect to H.R. 4503, I have the following suggestions:

1. **Page 6, line 23.** Add margin requirements as a subject to be covered.

2. **Page 7, line 21.** The language is quite soft. You might wish to consider providing the regulatory authorities the "power to implement" regulations, not merely make recommendations (to whom?) with respect to the subject matters on Pages 8 and 9.

3. **Pages 10 and 11.** All references to "revenue gains and losses" might explicitly include the phrase, "whether or not realized."

4. **Pages 29 and 30.** The term "speculation" should be avoided in the Bill. Any financial decision is "speculative." Alternatively, you might wish to consider using the term "leveraged" where appropriate.

5. Finally, I would suggest that the study of margin and collateral be the responsibility of the Federal Reserve Board.

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This brings me to my final point and, to my own mind, the most important. We have enough essays, surveys, studies, green books, Basle guidelines, international studies about credit risk,

basis risk, legal risk, event risk, operational risk. They are all fine and so will be future ones -- whether mandated by legislation or done voluntarily. But they all read like a cross between graduate school theses, at best, and a public policy consultant's think-piece. We are writing essays without really knowing, in a systematic fashion, how the market works. We need far more precise day-to-day market information on who does what; how is it financed; how do bankers and dealers pass on their risks; how is leverage actually accomplished, etc.

The time is now, I suggest, for a "Special Study," under oath, with subpoena power, conducted independently, reporting directly to Congress, with such commentary by the Federal Reserve, Treasury, Comptroller of the Currency, SEC, CFTC, and anyone else who would like to comment on the ultimate analyses and conclusions of the Study.

The Chairman of the SEC and Chairwoman-Designate of the CFTC should designate a Director of the Study and then let that Director staff the Study -- with subpoena power. We will not find out how the market really works without such a Study. Why subpoena power? Let me remind this Committee that at the time of the Salomon Brothers affair almost three years ago, which had many of the elements of the subject now being looked at, no securities firm would voluntarily testify about their operations in the REPO and government securities market. Nor will they do so fully and frankly about derivatives in response to a letter from the Secretary of Treasury or the Chairman of the Federal Reserve.

They will under oath. And that is the way to develop a body of knowledge in this particular area. The alternative is to rely on Grand Juries, SEC investigations after the fact, class action lawsuits and surveys.

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 <u>its</u> 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.