

TESTIMONY OF RICHARD MCCORMACK

SENATE BANKING SUBCOMMITTEE ON  
INTERNATIONAL TRADE AND FINANCE:  
HEARINGS ON DERIVATIVES AND HEDGE FUNDS

May 16, 2006

Mr. Chairman and Distinguished Members of the Subcommittee:

My name is Richard McCormack. I am a senior advisor for the Center for Strategic and International Studies and a former Undersecretary of State for Economic Affairs. I appreciate the opportunity to testify before this Subcommittee on the issue of derivatives and hedge funds. The hearings today are very timely.

Today, I want to make four major points.

1. The global economy, while now at the peak of the business cycle, is full of vulnerabilities that could strain financial markets if an unexpected shock were to strike.
2. Over leveraged hedge funds and poorly understood derivative investments are potential triggers or amplifiers of a future financial crisis.
3. Today's hedge funds command 1.3 trillion dollars worth of capital invested in almost all kinds of market activity, including the 200 to 300 trillion dollar derivative industry.
4. The U.S. regulatory system has largely served us well in the past, but the increasing complexity and internationalization of finance and investment suggest the need for an ever more global approach to monitoring potentially dangerous problems.

## BACKGROUND

During the past several months, there have been a number of important speeches by U.S. officials on derivatives and hedge funds. A February 28<sup>th</sup> presentation by New York Federal Reserve president, Timothy Geithner, Risk Management Challenges in the U.S. Financial System, describes some of the potential threats to financial stability posed by this very large industry. In a March 9<sup>th</sup> presentation, Assistant Secretary of the Treasury, Emil Henry, formerly from Wall Street, provided an excellent overview of the industry and noted some of the technical questions that require further attention.

Virtually everyone who understands the derivative industry recognizes its value to the economy in its ability to manage, transfer, and diffuse financial risks by individuals and companies. It also generates large profits for many of those participating in this industry, as well as the potential for losses, particularly during periods of turmoil in financial markets.

Some derivatives also contain the potential for abuse. For example, Italy secured entrance into the Euro by purchasing exotic derivatives that obscured the true financial condition of the country until after Italy was admitted. A similar situation occurred when some Japanese banks purchased derivative instruments which disguised the actual catastrophic state of their balance sheets at the time. We all remember, as well, problems with Enron and other institutions where derivatives played a key role in clouding the actual financial condition of individual institutions.

We also know that in the past there have been spectacular examples of turmoil in financial markets that were caused by honest miscalculations by important players in the derivative industry. The Long-Term Capital Management debacle of 1998 was the most recent example, and it threatened the soundness of financial markets.

It is important to remember, however, that for each Enron-type problem that surfaces in connection with derivatives, there are thousands of derivative transactions that occur every day which benefit all parties involved. For that reason, it is important to approach the potential problems with great care and sophistication.

The challenge we have now is to examine this industry, with the help of those deeply involved in it, to identify and correct, if we can, any structural or technical problems that could increase the likelihood of systemic risk in the event of future shock to the financial system, such as the Russian default in 1998. Political risk and market over reaction in a crisis are, however, difficult to predict, prevent, or completely factor into economic risk modeling.

History suggests that we may not be totally successful in efforts of prevention, and that any future financial turmoil may well resonate in parts of the derivative market.

Furthermore, there is no such thing as a permanent fix to problems in the derivative industry. This industry is so dynamic that its strengths and weaknesses change every few

years. Ten years ago, credit derivatives were a tiny blip on the screen. Today these credit derivatives, which provide a kind of default insurance to creditors, are the fastest growing segment of this industry, as much as \$15 trillion of notional value.

Last year when serious operational problems in credit derivative markets alarmed regulators, Gerald Corrigan, a former senior Federal Reserve official, now with Goldman Sachs, led an effort to identify and repair these problems. This effort was a good example of how industry and regulators can work together to address problems on the operational side of the derivative business. The Report of the Counterparty Risk Management Policy Group of July 27, 2005 is a masterpiece of its kind. Many of the larger institutions in the derivative business have subsequently moved to comply with needed reforms by hiring expensive software and putting systems in place to expedite the clearance process. It has taken some effort, however, by the New York Federal Reserve Bank and other regulatory bodies to get the some of second tier hedge funds to make the needed investment in back office staff and systems.

Other potential problems have also been considered, such as credit risk that poorly vetted counter parties might pose if those offering derivative insurance do not have the capital strength to pay up in event of major defaults. As needed reforms are implemented, greater confidence will develop that investors and their creditors will only have to worry about market risk, not potential legal challenges and operational uncertainties.

We should not forget, however, that serious and potentially dangerous problems developed in the credit derivative markets before they were identified and addressed. It suggests that there is little room for future complacency in monitoring other parts of this rapidly evolving 300 trillion dollar financial activity.

Beyond operational and credit risk, market risks pose another set of issues.

The global macro economic picture today is highly positive, with global growth at 5% and with several years of U.S. growth exceeding 4%. Long periods of growth and prosperity tend to induce a certain amount of complacency in financial markets. It is important, however, to remind the growing number of pension funds and other more recent derivative investors that the business cycle still exists. A world previously awash in liquidity, plus the rapid turn over in debt instruments of all kinds, from housing mortgages, to third world bonds, to many forms of derivatives, may have reduced the incentive and the care by which some of the primary issuers of credit instruments vet and price long term credit risk. Commissions, not considerations of long term credit worthiness, may sometimes be the real deal drivers. Nervousness about possible future credit risk may explain, in part, the increasing popularity of credit derivative insurance. Yet that credit risk, while diffuse and therefore less of a threat to individual institutions, still exists in macro economic form, and collectively may weaken the future general economy during a period of strain.

There are also other potential vulnerabilities in the global economy that could impact financial markets at some point. I have noted many of these in a recently published analysis, which I attach as an appendix to this testimony.

## RECOMMENDATIONS AND OBSERVATIONS

Mr. Chairman and Distinguished Members, I would like to conclude my remarks by making several recommendations and observations:

All involved need to continue efforts to better understand the rapidly evolving derivative and hedge fund industries. For example, estimates of the total size of the notional value of over-the-counter derivative contracts outstanding vary widely. The President of the New York Federal Reserve Bank estimates the number at \$300 trillion. The Bank for International Settlements places the number at \$270 trillion, while the International Swaps and Derivative Association estimates a notional value of \$219 trillion.

Even value at risk, which is a much smaller number, is subject to varying interpretations and estimates.

When rounding errors for estimates for notional value of outstanding derivative contracts are in the tens of trillions of dollars, it is hard to have total confidence that we understand all the potential vulnerabilities that may exist in this vast market and industry. With these enormous gaps in our macro picture, how is realistic stress testing of the system even

possible, quite apart from the uncertainties that rapid crisis-driven market dynamics, complex cross sectoral impact, and political decisions inherently constrain this kind of risk analysis?

One of the key drivers of the 1987 stock market crash was the computerized program trading in stocks and derivatives. The stop-loss sell orders factored into these program trading systems threatened to cause financial markets to implode, requiring desperate liquidity injection efforts by the Federal Reserve. Not all of today's hedge funds are managed by cutting edge econometricians and Nobel prize winners of the kind that ran the Long Term Capital Management hedge fund before its collapse. There are a lot of momentum driven, computerized, and highly crowded trades in today's hedge fund and derivative world, which raises concerns about possible herd like behavior in a future financial crisis.

In his February 28, 2006 presentation on financial risk, Mr. Geithner discusses a potential rush to the exit by highly leveraged derivative investors during a future period of market turmoil. Any sudden large scale redemptions of capital in hedge funds, whose 1.3 trillion dollars are now an important market driver, would add to any future market liquidity problems in a crisis. Such developments could lead to markets failing to clear efficiently. Liquidity shortages are why markets melt down so fast and overshoot in some crises, as was the case in the 1987 stock market debacle.

Obviously the Federal Reserve can again play a role in addressing certain kinds of liquidity shortages in a crisis, but individual investors should be mindful of the need for an adequate capital cushion to address potentially unfavorable market developments. The issue of potential liquidity shortages during a crisis is one that deserves further study.

As more and more investor groups and pension funds become involved in the derivative business, after a long period of growth and economic stability, some investors, attracted by high yields, may be tempted to take on risks that they do not fully understand. Should early signs of possible vulnerability begin to appear, the most sophisticated investors will, of course, quickly shed risky investments. Remember, for example, what happened to Argentine bonds: Before the spectacular default, they ended up in the hands of Belgian dentists and Italian pensioners. These hearings should serve as a reminder to investors of the oldest lesson in business dealings: caveat emptor: let the buyer beware. Complex derivatives are not a place for amateur investors. There is an enduring connection between high yields and high risk.

The derivative industry itself has a powerful incentive to avoid the fraud, abuse, and blunders that could lead to massive losses, scandals, and crippling future regulation. The statesmen in the derivative industry are also best positioned to point out to regulators potential structural problems and those few in their ranks who may be engaged in unscrupulous or sloppy business practices.



Regulation of the derivative industry is faced with a fundamental dilemma; if governments regulate the industry so tightly as to avoid all risk of market failure, it will kill a valuable part of the financial system. Finding the right middle path in this constantly changing environment is a challenging task that can only happen with the closest collaboration between the most sophisticated parts of the industry and their counterparts in the regulatory and political systems.

The U.S. regulatory system monitoring the financial industry is highly fragmented. Because of rapid changes in the industry itself, investment banks, hedge funds, and government-sponsored groups such as Fanny Mae have taken over functions that were once the prerogative of banks. Since banks are more highly regulated, there has been a trend of doing more and more financial business in areas where there is less official regulation. This includes the off shoring of some of the industry to places such as the Cayman Islands.

If the U.S Government were to start from scratch and design a regulatory system for today's financial system, it would not look like the system we now have in place, even though the existing system has generally served us well. With the increasing globalization of the financial industry, however, it is clear that more of the regulatory emphasis will have to be international in character. This is not going to be easy.

Different national regulatory traditions and competitive interests, plus the sheer size and complexity of the task pose large challenges. The Basel 2 capital regulation effort has involved supervisors, regulators, and academics for many years, but thus far they have

been unable to find an agreed industry standard for the measurement, management, and modeling of credit risk. Indeed, other individual countries are already in the process of tightening regulation and forcing increasing transparency of hedge fund activities.

As the analysis and negotiation process unfolds in the year or two ahead, regulators will need to make sure that derivatives continue to be remarkable instruments of wealth creation, global development, and risk diffusion, and not as Barton Biggs, Morgan Stanley's chief global strategist once feared "the nuclear weapon that ultimately blows us all to smithereens."

All of us hope that the current global economic boom can be gently managed downward to avoid potential inflationary problems. But with the dollar under pressure from our ever growing current account problem, with oil and commodity markets under strain, and with geo political uncertainties intensifying, the potential exists for a somewhat more rapid market reaction at some point.

The entire global financial system is interconnected by hundreds of trillions of dollars of derivatives. For example, any future banking or political crisis in China, which significantly slows that economy, would immediately impact commodity prices, bonds, and derivatives of commodity producers. Any further sustained spike in oil prices could impact huge segments of the derivative industry and their bankers. Those holding some credit derivatives against default could find them costly indeed if significant chunks of the global economy were to experience a future recession.

During this current period of relative tranquility and prosperity, therefore, it is important for governments and industry to continue efforts to monitor closely financial markets that could come under future strain and address new structural problems as they are identified. This effort will require judgment, sophistication, common sense, and contingency planning by all those involved in this industry and their regulators.

In conclusion, in well functioning financial markets we should not be concerned about the gains and losses of individual derivative investors. That is what capitalism is all about, and one of the reasons why this country is so prosperous. We take risks; we invest capital; and the market apportions the winners and the losers. Our concern should be any potential systemic risk, fraud, inappropriate market manipulation, and structural problems that increase the possibility of a future financial market melt down with devastating impact on the real economy, and on the lives of millions of people.

Thank you.

Attachment: “Looking Forward in Wartime: Vulnerabilities in the Global Economy.”

Lead essay by Richard McCormack in Carlos M Pelaez and Carlos A Pelaez:

:*International Financial Architecture: G-7, IMF, BIS, Debtors and Creditors* .(

(Basingstoke, UK, and New York: Palgrave Macmillan 2005).