October 4: Market Risk - World Regulators Focus on Derivatives

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Officials from Britain's Financial Services Authority, the Federal Reserve Bank of New York and SEC want to tighten up derivatives markets, where explosive growth in recent times has fueled fears of a potential financial disaster. They warn that countries must join forces to help contain risks posed by the rapid global expansion of derivatives.

In the Financial Times on Thursday, Timothy Geithner, president of the New York Fed, Callum McCarthy, chairman of the FSA, and Annette Nazareth, a commissioner at the SEC wrote in a joint letter, "Often it takes a crisis to generate the will and energy needed to solve a problem. "Here, the industry deserves credit for acting in advance of a crisis." Progress has been made during the past year, but "there is still work to do" regarding regulation of derivatives, the letter added. "In a more integrated global market, we will increasingly find ourselves compelled to pursue borderless solutions." It continued: "Weaknesses remain and, apart from operational risk, the market faces formidable challenges in measuring and managing financial risks."

Derivatives are no longer the domain of specialized hedge-funds, but are also used by traditional investors such as investment banks. The letter came after leading global investment banks, institutional investors and international regulators met in New York on Wednesday to discuss industry initiatives to improve back-office systems for derivatives trading. The move followed concerns last year that back-office backlogs were so serious they could create systemic problems if not addressed, according to the Financial Times. At the meeting, regulators said a process of co-operation between US and European regulators last year had cut credit derivatives backlogs. "In the case of derivatives, a local or national solution would have been insufficient to protect domestic financial markets from the risks posed by market practices," the letter continued.

The officials meanwhile warned that the industry still needed to tackle serious backlogs in equity derivatives. The market for credit derivatives was worth about $26 trillion in the first half of 2006, according data from industry body the International Swaps and Derivatives Association. Credit derivatives accounted for just $631 billion worth of trade during the first half of 2001.

Meanwhile, hedge funds are also facing calls for closer regulation. Concern reached the US House of Representatives last week, as lawmakers debated a bill that would require a White House body to devise recommendations on hedge fund disclosure requirements. There are thousands of hedge funds worldwide, which combined, control assets totaling more than one trillion dollars, according to recent US government and industry estimates. Because the sector is largely unregulated in the United States, the US government does not know how many hedge funds exist or how much cash they control. Some experts believe hedge fund trades account for 30 percent of all US stock trading volume.
