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Regulate OTC Derivatives By Deregulating Them: Response to Comments

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Response

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In my paper, I proposed that we consider "regulating" the over-the-counter (OTC) derivatives market the same way the common law did: by refusing to enforce an OTC derivative contract unless one of the parties to the contract is truly using it for hedging (insurance) rather than for speculation. In their responses, Jean Helwege, Peter Wallison, and Craig Pirrong each object to this idea for a variety of reasons. Their objections, however, can be boiled down to two basic complaints:

- It is impossible as a practical matter to distinguish speculation from hedging.
- Speculation is either not harmful or is an affirmatively beneficial activity, and should thus not be restrained.

HEDGERS VS. SPECULATORS Any lawyer familiar with the basic principles of insurance law will recognize the first objection as groundless. In the insurance industry, both courts and insurance companies have been distinguishing between the use of insurance contracts for hedging and their use for speculation for centuries. One does not have to be a particularly "wise judge" (to use Craig Pirrong's phrase) to recognize that when someone buys insurance on a home he does not own, the insurance is being used to make a speculative bet rather than to hedge. Similarly, one does not have to be a particularly wise judge to recognize the difference between a "naked" credit default swap and a credit default swap where one of the parties actually owns the underlying bond that might default.

More importantly, the genius of the common law was that it did not really put the burden on judges to distinguish hedging from speculation – it put the burden on the parties themselves. It is not judges but insurance companies that take the lead in investigating their contract counterparties to make sure that someone seeking to buy an insurance contract actually has an "insurable interest." Similarly, the common law rule puts the burden on OTC derivatives traders to make sure that at least one of the parties to a contract has an "insurable interest" in the underlying. Because both parties want the transaction to take place, they have every reason to cooperate with each other and exchange the information necessary to assure themselves the contract is a legally enforceable hedge.

PROTECTION? The second objection to the common law rule – that there is no reason to disfavor purely speculative transactions because speculation is either harmless or affirmatively beneficial – involves a leap of faith that defies both logic and experience. This is because the objection assumes, without empirical evidence, that most buyers of credit default swaps (CDSs) are, as Peter Wallison puts it, "buying protection." In other words, it assumes the vast majority of OTC derivatives contracts involve a hedger on one side of the contract and a speculator on the other.

Yet there is no logical reason to assume speculators always trade with hedgers, never with other speculators. Quite the contrary. If John thinks that a company's credit rating is going to rise and Mary thinks the rating is going to fall, it is only logical for both to believe they can make money trading CDSs with each other. One of them inevitably will be proven wrong. This reality is the key to understanding why purely speculative trading is troubling from a social welfare perspective. Unlike the typical market transactions praised by Adam Smith, which leave both parties better off, purely speculative trades by definition leave one party a winner and the other a loser. Meanwhile, both have been exposed to risk they weren't exposed to before. John will lose if ratings fall; Mary will lose if they rise. But for the swap, neither would be at risk of losing anything.

Accordingly, reason itself suggests that markets dominated by speculators can contribute to systemic risk. If we want evidence, we need look no further than recent business history. AIG and Goldman Sachs both took on risk when they traded CDSs on bonds that neither actually owned. When credit ratings fell, Goldman Sachs won big while AIG lost big. This would not be a problem if no one else were involved – but U.S. taxpayers did become involved, to the tune of $180 billion.

In other words, we know that unrestrained speculation in OTC derivatives can contribute to systemic risk *because that is exactly what it did.* Rather than repeating our recent unpleasant economic experience, we would be wise to learn from it.

As Jean Helwege points out, there are many ways governments can keep speculators from overwhelming a market, for example by imposing margin requirements, raising minimum capital requirements, or avoiding loose monetary policy that gives would-be gamblers too easy credit. But why assume only government can do the job?

History teaches that there are private options available. By making purely speculative derivatives contracts legally unenforceable, the common law encouraged would-be speculators to organize their own private exchanges. In turn, the exchanges imposed membership requirements, margin requirements, and minimum capital rules. As a result, speculators had a place to go to make their bets and contribute to liquidity and price discovery – without also contributing excessive systemic risk.

Government intervention can indeed solve some problems. But we should not forget that private ordering can solve problems, too. ■

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