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Derivatives Aren't the Danger

By Thomas C. Theobald

As a nation, we've compromised lots of free-market principles in recent years. But, even so, it is hard to imagine Congress passing a law forbidding businesses to borrow once interest rates rose past an arbitrary point, mandating a specific capital structure, or outlawing fixed-rate loans. Until last week, it would have been harder still to conceive of federal regulations that forced companies to assume identifiable risks—such as exposures to sudden shifts in exchange rates or unforeseen swings in commodities prices—that they would prefer not to take, and that might even put them out of business.

REGULATORY CHOKEHOLD

Hard as it may be to believe, those scenarios are being promoted in Washington, as the House Energy and Commerce subcommittee on finance this week continues to hear testimony on legislation regulating the use of financial derivatives.

The General Accounting Office's report released last week asserts that "there ought to be a law" regulating derivatives, citing the 1987 stock market crash, the savings and loan debacle, and the breakdown of the European monetary system. In none of these cases, however, were derivatives the problem. Indeed, a reasoned retrospective view may question whether any of those three events would have been prevented by any conceivable kind of legislation.

For all the talk about the complexities of the derivatives markets, the basic function of these tools is simple: Whether traded on an exchange or structured in the over-the-counter market to manage a specific financial exposure, derivatives allow business users, ranging from farmers to major corporations and government agencies, to achieve certainty about future costs and revenue streams in an uncertain world, and to do so with remarkable efficiency.

Of course, derivatives—like cash instruments—also allow business users to take a view on the direction of interest rates, exchange rates, or commodities prices: that is, to speculate. If the users' views happen to be right, derivatives can be efficient money makers. If the users' views happen to be wrong, however, derivatives can erase earnings just as efficiently, as a few companies have recently and unfortunately found.

Certainly, those losses are regrettable. No one likes to see respected companies take earnings hits. But those losses are inherently no more regrettable than if they had resulted from a major marketing miscue, the expenditure of millions of research and development dollars on a product that bombed, or a substantial operating blunder. Congress would be unlikely to consider legislative or regulatory controls on marketing or manufacturing strategies to protect the minority that make poor or "speculative" marketing or operating decisions. So why should it consider writing laws to insulate the small percentage of firms that make risk management mistakes?

The answer, to put it bluntly, is that it shouldn't.

Extensive SEC and Federal Reserve studies of the issue—and research from the academic community—agree that, far from a serious, or even a significant, threat to the nation's financial system, derivatives have been an important stabilizing factor. The use of derivatives by banks and other financial institutions in managing their balance sheets is actively encouraged by regulators to prevent the sort of asset/liability mismatches that produced the savings-and-loan debacle.

Rumblings of legislation to control the purchase or sale of derivatives threaten not only to put certain dealers, like U.S. commercial banks, at a disadvantage vis-a-vis other providers, but also threaten to undermine the efforts of companies using derivatives to their shareholders' benefit. Is Congress going to decide who should be allowed to benefit from using these instruments while forcing others to wing it, hoping interest rates, exchange rates or commodity prices won't move to their disadvantage?

The real aim in Washington appears to be regulation of derivatives users, the individual companies that participate in derivatives markets. The problem is that in protecting some firms from making poor financial decisions, new legislation may prevent many more companies from making smart ones.

Washington and the Financial Accounting Standards Board may appropriately set standards for corporate financial disclosure of derivatives activities. We at Continental Bank Corp. encourage our clients to discuss these issues with their top managements, to ask questions until they are satisfied, to set clear policies and internal controls. Risk management is an integral part of running a successful business, and investors have the right to expect companies that use derivatives to state their risk-management policies clearly and stick to them.

But the responsibility for setting financial policies and implementing financing strategies—including the use of derivatives—should belong to owners, managers, and boards of directors. Managers who make informed decisions and have appropriate internal controls in place to ensure that their derivatives activities support their financial and business objectives will emerge as winners in the marketplace. Those that don't will be losers, subject to the discipline of the market.

That discipline may be harsh at times, but in the long run free markets are far more effective than a roster of prohibitive laws and regulations. All companies should have the ability to make informed, intelligent decisions to manage existing, identifiable—and avoidable—risks.

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