'Plain Vanilla' Derivatives Can Also Be Poison

WSJ **COMMODITIES**

3/20/95 By SUZANNE MCGEE C1
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BOCA RATON, Fla. – Just because derivatives are exchange-traded doesn't mean they're less risky than the privately traded types that cause so much loathing and dread.

That's the point that risk-management analysts and futures-industry gurus are seeking to drive home at a conference here in the wake of the collapse of Barings PLC. The British investment bank's demise didn't result from the largely unregulated "over-the-counter" derivatives market, but from immense, poorly managed bets on "plain vanilla" futures and options listed on closely supervised exchanges.

While there are important distinctions between the hazards of exchange-traded futures and options and much-maligned OTC products, all derivatives have an essential risk in common: Because they allow people to take huge market gambles with little money down, they're enticing to speculators. Yet speculating with such powerful tools magnifies the risk of sudden, large losses for those whose bets go wrong.

Derivatives are financial agreements whose returns are linked to, or derived from, the performance of some underlying asset, such as bonds, currencies or commodities.

"It doesn't really matter if you're dealing with cash instruments, like stocks or bonds, or OTC derivatives, or the futures markets," argues Leslie Rahl, principal at Capital Markets Risk Advisors Inc., a New York consulting firm that helped diagnose derivatives ailments of Orange County, Calif., among others. "They all carry risk." For instance, even normal stock and bond holdings can be turbo-charged when bought on margin, or with borrowed money.

No matter what tools one prefers to use, the key thing is "to understand exactly what kind of risk you're taking," Ms. Rahl stressed.

An investor who opts to use OTC derivatives faces a number of special hazards. For one thing, OTC options and other products tend to be more customized than exchange-traded derivatives. And that may sharply reduce liquidity, or the investor's ability to leave the position quickly without taking a pounding. What's more, liquidity is especially likely to dry up in times of market stress – precisely the conditions where it's most critical.

Another thorny issue with OTC derivatives is "counter-party credit risk," where the investor runs the risk that the party on the other side of the transaction might be

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unable or unwilling to make good on its obligations. Because one's trading partner is more likely to fail in times of market crisis, this risk may resonate in ominous ways with both market risk and liquidity risk.

In the worst of all worlds, one ends up with "systemic risk," or the chance that a catastrophe at one firm or in one part of the market can trigger crises at other firms, potentially causing a chain reaction that damages the whole financial system. This scenario, generally considered a long shot by all but the most angst-ridden regulators and risk managers, has taken on new significance in the wake of Barings' sudden collapse.

While exchange listing doesn't eliminate all these risks, it does reduce them. To begin with, exchanges require traders to put up margin, or collateral, against their positions. What's more, the exchange's clearing facility acts as middleman to guarantee that all trades will be made good if one side fails to perform. As a result, failures tend to be more contained. And losses that exceed the failed firm's collateral are shared by all the exchange members.

"With an OTC contract, if your counterparty blows up and you're owed $1 billion, you could see that vanish," says Robert Arnott, president of First Quadrant Corp., a money manager whose asset-allocation strategies traded $60 billion of listed derivatives last year. "With exchange-traded products, that clearly hasn't happened. They acquitted themselves very well – the exchanges stood firm."

Meanwhile, the OTC market is moving to adopt credit safeguards that closely resemble those required by futures exchanges. Gary Gastineau, a New York risk-management analyst, notes that OTC-market participants are cutting counter-party risk by "increasingly making provisions for some kind of collateral deposit that minimizes credit risk." In effect, OTC players are imposing the same types of margin requirements on one another as exist for exchange-traded options and futures.

"I wouldn't make the broad-based distinction that exchange-traded derivatives are, by definition, safe investments, and that you should shun OTC products," contends Gary Bergstrom, president of Acadian Asset Management, another asset-allocation specialist that makes heavy use of derivatives.

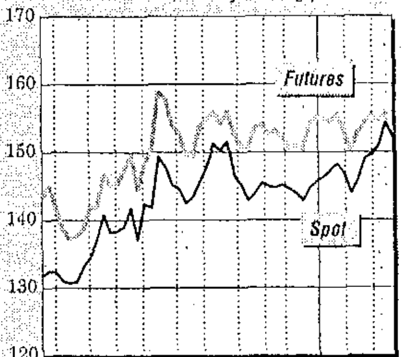
Indeed, some of the biggest derivatives blow-ups have involved the listed markets, Mr. Bergstrom and others note. Besides the Barings situation, which resulted in losses of some $1 billion, the German industrial giant Metallgesellschaft AG lost nearly $1.5 billion, largely through oil-futures trading on the New York Mercantile Exchange. And Chile's state-owned copper-producing enterprise, Codelco, saw half of its 1993 profit evaporate as a result of speculative trading in copper futures on the London Metal Exchange. "Derivatives, when used carelessly, can be dangerous," says First Quadrant's Mr. Arnott. "These events have just added an exclamation point to that statement."

The Barings disaster has highlighted another risk shared by OTC and exchange-traded derivatives alike: "The common theme is one of insufficient oversight within firms," Ms. Rahl said. What worries some risk-management professionals is the idea that an unsupervised gunslinger on some far-flung trading desk could trigger a similar blowup that might not be so quickly absorbed by the system.

Mr. Arnott and others like him, who employ derivatives-intensive investment strategies, are bracing for a flood of phone calls from concerned clients wanting to know how they're protected from the risks of dealing in the listed market. In the wake of the Barings debacle, "an exhaustive review, top to bottom, is going on of all types of derivatives," whether OTC products or not, said Benjamin Wolkowitz, managing director of Morgan Stanley & Co. in New York.

That review process could itself go a long way toward nipping potential Barings in the bud. Money managers agree that, thanks to Barings' experience, their firms aren't only reviewing their own policies, but are increasingly likely to scrutinize the structure, regulations and capitalization of the exchanges on which they do business.

Commodity Prices



Friday, March 17, 1995

	Close	Net Chg.	Yr. Ago
Dow Jones Futures	152.82	– 1.22	143.49
Dow Jones Spot	152.44	– 0.76	131.85
Reuter United Kingdom	2320.1	– 16.4	1831.9
K R-C R B Futures*	235.33	....	228.57

*Division of Knight-Ridder.

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