A REFLECTION ON FINANCIAL MARKETS

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Abstract

In 1972 the International Monetary Market (the "IMM") was launched in order to provide the financial world the same ability as the agriculture industry to manage risk. At the time, no one knew if the IMM would succeed, have any merit, or be accepted by other members of the financial world. The IMM's commencement was before the age of technology—before the onset of computers. Once computers existed, financial engineers had the ability to electronically allocate risk and the world began to acclimate to the idea of computer-generated financial derivatives. This Article stresses that full disclosure and transparency is dire in the realm of derivatives. In order to promote disclosure and transparency, there must be rules and regulations. Via the imposition of rules and regulations, regulators have the duty to make sure that the financial assets of this generation continue to exist for the future generations.

Article

Forty years ago, in 1972, at the launch of the International Monetary Market (the "IMM"), I was acutely aware that we were embarking into uncharted waters. We were introducing a revolutionary idea in the world of markets, an invention that would offer participants in finance the same ability to manage risk as their counterparts in agriculture had been doing for centuries. We had no proof that the idea would work, that it was of value, or that it would be accepted by the financial world. It was a scary and dangerous moment. It represented for me an impossible dream.

Of course, at the time of its launch in 1972, I had no knowledge that computer technology would within a decade materially change everything in life, including financial markets. In the latter half of the twentieth century, computer technology enabled mankind to peer into the fundamental components of nature. And just as in physical science technology brought us to subatomic particles, just as in biological science technology brought us to gene engineering, so in financial markets, the evolution was strikingly similar. Computer technology offered financial engineers the ability to divide financial risk into its separate components. We moved from macro to micro financial applications. Indeed, derivatives are the equivalents to particle physics and molecular biology. The most complicated risk management structure could suddenly be broken down into its fundamental components.

Financial engineers began to disaggregate, repackage, and redistribute risks and their corresponding rewards, exchanging one set of risks and rewards for another that responded better to an investor's preferences. The former chairman of Bankers Trust, Charles Sanford, called it, "particle finance." Particle finance impacted every aspect of finance and investment. The world moved forward and enthusiastically embraced the idea of computer-generated financial derivatives. They represent the most cost-efficient instruments with which to manage risk.

With this caveat, however, full disclosure and transparency in financial reporting is critical in the use of derivatives. There must be rules and regulations. Recent requirements to bring OTC derivatives onto a clearing entity such as an exchange is an important step in the right direction. I also applaud recent moves to strengthen electronic trade across both securities and futures markets.

As we are all aware, the 2007–08 crises resulted in giving financial derivatives a bad name. In some uninformed quarters, it became a nasty word. Who can forget that Warren Buffet called derivatives, "weapons of mass destruction?" Never mind that his enterprise, Berkshire Hathaway, uses derivatives to hedge its considerable risks in business.

In December 2007, The Bank of International Settlements ("BIS") estimated that in notional terms there were $586 trillion outstanding derivatives in the OTC market. This was at the outset of the financial crisis. Four years later, as of December 2011, the BIS told us that there were in notional terms over $647 trillion outstanding derivatives in the OTC market. Why the increase? Because it is the instrument of choice when insuring one's risk. The world has not yet invented a more efficient or less costly alternative with which to insure and manage business risk.

In his most recent book, *Finance and the Good Society*, the noted Yale economist Robert Shiller, who was the only one to correctly predict the U.S. housing bubble, explains that if firms and individuals cannot insure themselves against bad outcomes, they will necessarily be cautious. Instead of using capital to expand their business and other creative purposes, they will save it for insurance purposes. Consequently, the economy will grow more slowly than it should.

Our nation's futures markets are an outstanding example of "American Exceptionalism." They are a crucible for innovation and job creation. Their central-counterparty-clearing model has been mandated for much of the OTC market. They represent an American natural resource. It is the duty of the regulators not only to keep up with the markets, but as Teddy Roosevelt admonished in a different context, they must treat our natural resources, "*as assets which it must turn over to the next generation*."