

SWISS DERIVATIVES *Review*

32nd Bürgenstock Meeting - Thursday, September 8, 2011

Thursday dawned partly cloudy, reducing the temptation to enjoy the outdoors and encouraging attendance at what turned out to be some very interesting panel discussions.

The morning's first panel was succinctly entitled, "Energy". It was moderated by **Dr. Giacomo Luciani**, Professor Graduate Institute of International Development Studies in Switzerland, who launched the discussion by pointing out that energy markets are now recognized as a separate asset class. He illustrated the complexity of energy markets, which goes far beyond the classic categories of oil, gas, oil production, coal, power and carbon markets.

John Damgard, President of the Futures & Options Association, outlined the progress and ramifications of the Dodd-Frank legislation, a partisan regulatory bill now winding its way cumbersomely through the maze of regulatory bodies and institutions, resulting in a walloping 55 proposed rules or direct orders for the derivatives industry. This blizzard of regulation comes as a slap in the face to an industry that saw itself as the good guys, and offers a huge opportunity for markets outside the U.S.

Timothy John Knight, Global Head of Commodity Futures, BNP Paribas Commodity Futures, agrees that the industry faces enormous and irreversible change. A perfect storm has brought us to a world where the concept of the cleared swap is now fully accepted and even embraced by the market, creating both a firewall and absolute oversight.

Geir Reigstad, Senior Vice President, NASDAQ OMX Commodities, pointed out that energy is truly a global market in which Chinese demand for coal impacts the price of electricity in Nordic countries. Cooperation is necessary in a global context to ensure liquidity, a level playing field, transparency in markets and lower entry barriers. He also sees political risk when national interests trump international market concerns such as Germany's recent unilateral decision to shut down its nuclear power plants. He fears that energy producers will shy away from regulated markets.

Henri Stevens, Procurement and Supply Chain Management Specialist, spoke as a former physical trader. He sees traders leaving the market in the face of rising complexity and regulation as well as an inherent limit to the role of clearing houses. To keep them in the game, traders must have a voice in the regulatory discussion.

Inga Posch, Senior Expert Market Regulations, Alpiq Trading AG, views market regulation from the financial side. Calls for greater regulation indicate a general lack of trust in energy trading and companies. In her view,

markets can deliver the right signals if you don't overburden them with regulation.

Providing a regulator's voice on the panel, **Volker Zuleger**, Senior Expert, E-Control Austria, admits that the blizzard of regulations is challenging the energy markets. Because of its complexity and different systemic risks, such regulation must be targeted to specific market needs.

The morning's second panel discussion, entitled, "OTC Clearing - The way forward" was moderated by **Dr. Giovanni Barone-Adesi**, professor of finance theory, Swiss Finance Institute, University of Lugano, who has witnessed both the early days of financial derivatives and the more recent drive towards the clearing of OTC trades. While he sees safety as a beautiful thing, too much makes business uncompetitive.

David Lawton, Head of Markets Infrastructure and Policy, Financial Services Authority, joined the panel with a regulator's perspective. OTC clearing is the way forward due to political imperative. The 2008 crisis revealed the difficulties of managing counterparty risk and showed regulators that they had no clear view of what the market and companies were up to. While European regulation lags behind what is being done in the U.S. they are both moving in the same direction towards standardization, though he questions whether there is truly a shared global vision of what the structure will be.

Matthias Graulich, Executive Director, Eurex, provided input from an exchange perspective. He sees OTC clearing as a step towards the objectives set by the G20 back in 2008, bringing a mutualization of risk and a containing of potential losses within the financial system. However, he also sees a danger of dilution of focus. Interoperable markets could increase systemic risks. We need an aligned approach and timetable for implementation.

Richard Metcalfe, Head of Global Policy, International Swaps and Derivatives Association, stated that liquidity within the system is essential. One of the biggest lessons learned from the 2008 crisis was that products that were assumed to have liquidity did not. He sees the benefit of multiparty clearing in spreading the exposure to risk. Yet, he also sees the industry heading towards a collateral crunch and a burning need to look at the interconnected issues.

Dr. Tina Hasenpusch, Head of Clearing and Business Development, CME Clearing Europe, logically listed the benefits of OTC trade clearing, including multilateral netting opportunities and the creation of firewalls. The industry must accept that the ongoing

changes are irreversible, while acknowledging that we need to effectively balance safety and efficiency on a global basis.

Daniel Marcus, Managing Director of Strategy and Business Development, Tradition Ltd, cautions that regulator arbitrage is to be avoided. He sees clearing as just one component in the movement towards reducing systemic risk. Some industry initiatives are even ahead of the regulation. Needed are objective criteria among clearing houses and equal access to market participants.

After lunch, a bearish keynote address by **Dr. Konrad Hummler**, Managing Partner, Weggelin & Co. had most attending participants sitting up and taking notice. He illustrated the history leading up to the current global financial situation using the example of a flourishing rain forest, overgrown by the tendrils of growing plants, with more than enough to nourish and even spoil the resident monkey population. But when the rains stopped and the bounty failed there was much wailing and gnashing of teeth.

This simplified vision was then fleshed out by Dr. Hummler with an outline of the history of what he views as the American economic cataclysm. It began with a good idea. There was to be enough liquidity for most Americans to own their own home, drive their own car and consume to their heart's content. Their institutions, both business and political, made sure the rains kept coming until all their savings were spent and consumers were virtually bankrupt. And still they went on to consume even more on credit, such private spending eventually comprising up to 70% of the U.S. economy. Keeping the bounty flowing became a key to political re-election. Institutions such as Fannie Mae and Freddie Mac were designed to get Americans into debit and keep them there. It became easier and easier to obtain credit to buy houses, which resulted in rising prices and eventually a real estate bubble. Meanwhile, Americans financed their consumer binging on the rising value of their homes in the belief that there was little risk; the liquidity would continue to flow. And they were right. Uniquely low interest rates meant a seemingly uninterrupted supply of free money. In their thirst for higher returns, investors assumed greater risk. The huge mass of sub-prime mortgages that was used to fuel America's consumer binger was minced into sausages and swallowed by the financial system mixed in with prime mortgages, the ratio of bad to good growing over time and swallowed by the financial system. And for a while the party continued. There was a collective blindness that caused most to miss the signs that seem so obvious in hindsight. Only the mother of all financial crises could cause this house of cards to fall. So it was when liquidity faltered in 2008, shock reverberated across the financial world and the party came to an abrupt halt.

Dr. Hummler noted the distinction between excessive debit and a liquidity crunch. Investors are willing to assume risk based on the assumption that repayment of capital and risk is probable. When repayment becomes improbable or not possible, then you have excessive debt.

The flood of liquidity released by central banks in response to the credit crisis was fundamentally the wrong approach according to Dr. Hummler.

Three years later it is clear that vast amounts of capital were destroyed. The banking sector was semi-nationalized. The systemic risk of excessive debit has moved from the private to the public sector, leading to crises in Greece, Ireland and Portugal, and the downgrading of the US credit rating.

Dr. Hummler sees three possibilities to remedy this grave situation. One is the provision of funds gifted by a third party, naturally with conditions. Or there can be an agreement to write off part of the debt. And finally, there is the option of bankruptcy, meaning sanctions for the debtor and loss for the creditor. All the possibilities mean painful restructuring. The current situation is that governments and institutions are doing their level best to avoid that pain, despite the fact that implicit debit is thought to exceed explicit debit by multiples.

Dr. Hummler wondered if perhaps the greatest crisis is represented by democracies making promises that cannot be met. We are living in a world where national budgets are neither risk-free nor unlimited.

The ongoing efforts to avoid the pain in Europe, such as with the European Financial Stability Fund, represent a false approach in Dr. Hummler's view, and such frantic efforts risk setting off the very domino effect to spread throughout the euro zone, and even perhaps splitting it. By buying up the debt of shaky countries, the European Central Bank is no longer an independent party and exposure to shared risks could lead to a contamination of sound economies.

And just as one thought Dr. Hummler could not paint a grimmer picture, he veered at the last moment to offer perhaps a glimmer of hope. Is capital inherently a danger to mankind? Not according to Dr. Hummler, who said that money, in and of itself, is the greatest source of freedom mankind has ever known. He called it a blessing, but one that depends entirely on the credibility of the symbolic value of money. Stop believing in it and money becomes worthless. The pot is now boiling and it means nothing less than a massive shifting of wealth and power as well as a re-evaluation of the preeminence of Western nations. Oh, and that there will be a reshuffling the cards rather than a total global economic meltdown, that was the good news.

After Dr. Hummler's fiery rhetoric, the afternoon's two panel sessions took a more rational course. The first, entitled, "High-frequency trading - Where will the profits come from?" was moderated by **Peter van Kleef**, CEO, Lakeview Capital Market Services, who got the discussion rolling by asking the panelists what they think will really give them the edge, and if high-frequency trading is scalable.

Mark Hemsley, CEO, BATS Europe, pointed out that as high-frequency trading has changed, it is no longer pure arbitrage. The playing field is more level now. The firms that profit are the intelligent ones with good models that they manage effectively. You must have a first class infrastructure to be a market maker, but it is not the sole consideration. High-frequency is just part of the price discovery process, Using public

information to trade at a fast past. He praised the efficiency of the American capital market and sees a need to remove inefficiencies from the European market.

Chris Lee, Global Head of Market Access and Electronic Brokerage, ABN AMRO Clearing Bank, began by pointing out that costs have risen dramatically to trade in these markets. The advantage now lies with improved intelligence, not just speed. High-frequency trading developed a bad reputation for its initial lack of sophistication and for being exploited. He sees regulation now stamping out the worst of it, leaving no holes to find on the clearing side. Mr. Lee does see the benefit of high-frequency trading, stating that the cheaper a trade can be made, the more people trade.

Dr. Christian Katz, CEO, SIX Swiss Exchange, signaled pride in the Swiss as early adopters of electronic trading, though he also sees the constant speeding up of technology as approaching the law of diminishing returns. SIX is a multi-asset exchange, and so far has managed to avoid over-investment and enjoys a growing membership. In today's high-paced market, arbitrage must necessarily shift from human to computer to keep up, and arbitrage is essential to market making, meaning that high-frequency trading has an important and growing role to play.

Hans Pieterse, Director, Optiver Europe, pointed out that the benefits of a market maker are not to be underestimated. High-frequency trading adds liquidity, reduces volatility and adds a great deal to the market. Yet, challenges are also arising in the high-frequency trading market with higher investments required for technology, research and wholesale trading. He welcomes the clear regulations being put into place with rules against malpractices.

After the coffee break, Thursday afternoon's second panel, entitled "The global financial markets: growth, debt, new roles" was ably moderated by **Rob Neale**, Managing Director, Neale Consultants Ltd. Echoing the famous Chinese curse, "may you live in interesting times," when there are so many issues whirling about that it is hard to know which one to worry about the most. And yet, he believes that not all is gloomy and perhaps there are even a few flickers of sunshine.

Dr. Michael Heise, Chief Economist and Head of Corporate Development, Allianz SE, admitted that he was unable to see any rays of sunshine in the current market environment. Markets are essentially irrational, usually leading or falling behind the fundamentals. Today they are nervous, selectively perceiving negatives and ignoring the positives. While he sees no true indication of a double dip recession, investors are losing confidence in governments' ability to reduce sovereign debt. While Europe seems to be moving towards greater austerity and lower deficits, in the US, the Obama administration is dipping further into negative spending to stimulate job growth.

Dr. Heise sees Greece as the biggest risk. It is dangerous to let weak countries fail. If one country defaults, exits the euro zone, then it could trigger a domino effect.

Stefan Bielmeier, Head of Research, Chief Economist, DZ Bank, considers the U.S. to be

structurally sounder, though growth is slower than expected. He feels that political will to act is lacking in Europe, while the U.S. speaks in a single voice. Equity markets dropped 30% recently in Europe, while in the U.S. it was only 5%. We are in a crisis of confidence and if we want markets to believe again, we need a clear target and a vision regarding public debt reduction. Europe needs a coalition to push people in the right direction, but he fears a further shock may be needed before consensus is reached. Mr. Bielmeier likes the idea of euro bonds combined with force austerity.

Dr. Guanping (Peter G.) Zhang, Deputy Director General, China Banking Regulatory Commission, spoke about the elephant in the room at this year's Bürgenstock Meeting, China. While they have heard much about U.S and European debt issues in recent years, the primary problems seemed to have so far been limited to smaller economies, such as Portugal and Greece. More alarming are the prospects for Spain and Italy, with a combined GDP exceeding Germany's. He mentioned concerns about bonds for these countries.

Looking back at the crisis of 2008, Mr. Zhang pointed out that in many ways recovery has been much faster than anticipated. He attributes this to the global cooperation of the G20. These larger economies are more difficult to repair. Efforts from a single country or continents are insufficient. What is needed is a joint effort in a timely manner.

But the question on the lips of some – will China ride the rescue? – went largely unanswered by this panelist, who pointed out that he is not in a position to answer that question. The Chinese leadership has expressed willingness to cooperate with the West. According to Mr. Zhang, the Chinese strive for a harmonic society and world. They believe in live and let live, to develop and let develop. Benefits should be shared globally and locally. Its actions shall be based on this principle. China looks to global cooperation. It alone cannot solve the problem.

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