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Notions on High and Low Finance

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## A Warning on Derivatives

As credit derivatives multiply, it is getting harder and harder to know who has taken on risks. And if you don't know that, it is impossible to know whether they could manage the risks in times of market stress or panic. Who has taken on the ultimate risk of defaults of subprime mortgages?

**Jean-Claude Trichet**, the president of the European Central Bank, delivered a thoughtful speech today to the International Swaps and Derivatives Association, the trade group of derivatives traders.

"It should be acknowledged that the opacity of the credit derivatives market, and especially of structured synthetic instruments, is a potential source of concern," he said. "The complex interaction between cash instruments and credit derivatives has made it increasingly difficult to monitor where different, possibly sizable, positions are taken and where risks are concentrated."

And what we don't know can hurt.

"As the instruments for sharing credit risk have not yet really been stress-tested, it is extremely difficult to ascertain the resilience of the market accurately," Mr. Trichet said, "Aggressive investors display a more volatile risk-taking attitude, and their balance sheets are not necessarily resilient enough to withstand major shocks or increases in volatility. In response to unanticipated events, their investment strategies may react in a way that can suddenly lead to dangerous herding behaviour and/or counterparty risk problems for banks."

In other words, who knows if those accumulating lots of risk now could afford to hold on in a time of crisis? And even if they could, would they panic and all try to get out together?

"In today's financial markets," he added, "the fear is that a large proportion of market participants may have become excessively complacent; a situation which may well have been exacerbated by high levels of liquidity, the stability of which is difficult to predict."

His solution is greater market transparency, but he concedes "there is as yet no broad consensus" on how that could be accomplished.

Meanwhile, the I.S.D.A., to which he spoke, reports that the notional volume of credit derivative swaps outstanding at the end of 2006 was $34.5 trillion. That was double the amount outstanding a year earlier, and four times the amount outstanding at the end of 2004.