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Swaps Come Under Fire

U.S. Regulators, European Leaders Seek More Oversight on Trades in Derivatives

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International momentum is building for stricter oversight of derivatives trading, as a top U.S. regulator recommended new limits on credit-default swaps and European leaders pushed for a ban on speculative bets against government debt following recent financial turmoil in Greece.

In the U.S., Commodity Futures Trading Commission Chairman Gary Gensler in a speech Tuesday offered his most-specific criticisms yet of credit-default swaps, the insurance-like contracts often blamed for the near-collapse of American International Group Inc. during the financial crisis.

He offered several recommendations to limit their use—though didn't go so far as to suggest a ban on speculative trading with credit-default swaps.

"We are to a surprising extent working well with international regulators," Mr. Gensler said in a question and answer session after the speech. "I'm optimistic we'll end up at roughly the same spot."

A spokesman said his agency doesn't have the authority to put some of his recommendations in place but would need to rely on Congress or other regulators.

German Chancellor Angela Merkel said Tuesday that her government is backing an initiative to curb the credit-default swaps market, together with France, Greece and Luxembourg, and she suggested Europe would forge ahead on its own even if the U.S. didn't go along.

José Manuel Barroso, president of the European Commission, the European Union's executive arm, said the commission would examine closely the possibility of banning outright "purely speculative" trading of the swaps.

The officials' comments mark their strongest stance yet against credit-default swaps. They fueled the growing debate about whether swaps contributed to the financial woes sweeping some European countries—or merely reflected them. Mr. Gensler, who has been calling for changes in how derivatives are traded for several months, on Tuesday grew more specific as he singled out credit-default swaps.

The U.S. Securities and Exchange Commission had no comment on the talks among European regulators about banning certain uses of credit-default swaps.

Greek Prime Minister George Papandreou brought his pitch for a crackdown on speculative trades in international financial markets to the White House Tuesday.

Mr. Papandreou said he "found a very positive response" from President Barack Obama on a European proposal to curb the kind of activity he believes has pushed up Greece's borrowing costs and could trigger another financial crisis.

It's unclear if any of these changes will get off the ground, or if the U.S. would be willing to go along with the European proposal.

An administration official said Mr. Obama's proposed regulatory overhaul, now making its way through Congress, would make trading more transparent and give regulators better tools to rein in manipulation.

These would include limits on the size of trading positions and rules on business conduct. White House spokesman Robert Gibbs didn't comment on the European swap proposals.

The European leaders Tuesday encouraged global action from the U.S. and other countries but made clear they wouldn't wait for it.

"It's important that this is done on the American side, too, but we think that a step ahead from our side, from the European Union, would help us," Ms. Merkel said.

Credit-default swaps function like insurance against a bond default. If a borrower defaults, the CDS holder is paid by the seller of the protection.

Traders don't need to own the bonds to buy the protection. Instead, they can use the contracts to make "naked bets" on a bond's direction.

In recent years, the credit-default swaps market has boomed. Seven years ago, less than $3 trillion of these contracts were outstanding; today that has topped $25 trillion, according to the International Swaps and Derivatives Association.

There is little publicly available information about who is buying and selling the contracts, which generally are negotiated in private, off-exchange deals. Thus it is hard for regulators and others to monitor who is on the hook for selling CDS contracts, and whether certain investors might be pressuring the contracts on, say, a nation's or company's debt.

As financial problems mounted for Greece and other euro-zone countries in recent months, prices of swaps insuring against debt default by those nations soared, drawing attention to the troubles and raising questions about whether speculation was worsening them.

Politicians increasingly lashed out against hedge funds and others assumed to be profiting as prices of the nations' bonds plunged.

While governments in Europe—where suspicion of financial markets and speculation tends to run high—have focused on credit-default swaps trading, a study released Monday by Germany's financial regulator, BaFin, found no evidence that credit-default swaps have been used to speculate against Greek national debt.

The study showed the net volume of outstanding credit-default contracts on Greek national debt has remained unchanged since January at about $9 billion. This compares to total Greek government debt of about $400 billion.

"The market data do not show massive speculation in CDSs," the regulator concluded.

The ban now being discussed in Europe would allow investors to use the contracts to hedge against possible defaults by government borrowers, but prevent them from taking purely speculative positions.

"It's hard to justify why market players should purchase insurance against risks to which they are not themselves exposed," Mr. Barroso said.

The contracts can provide helpful protection for those who own bonds or have other kinds of exposure.

Any attempt to restrict CDS trades could result in unintended consequences such as more risk for the financial system and higher borrowing costs for a range of nations and companies, some analysts and investors warn.

Restricting credit-default swap trading could push up borrowing costs for various nations if investors feel they have fewer ways to protect themselves if the bonds' prices decline.

Tuesday, the cost of CDS protection on debt of Greece, Italy, Portugal and Spain rose, though it's not clear how much of the moves, if any, were due to concerns about the future availability of credit-default swaps.

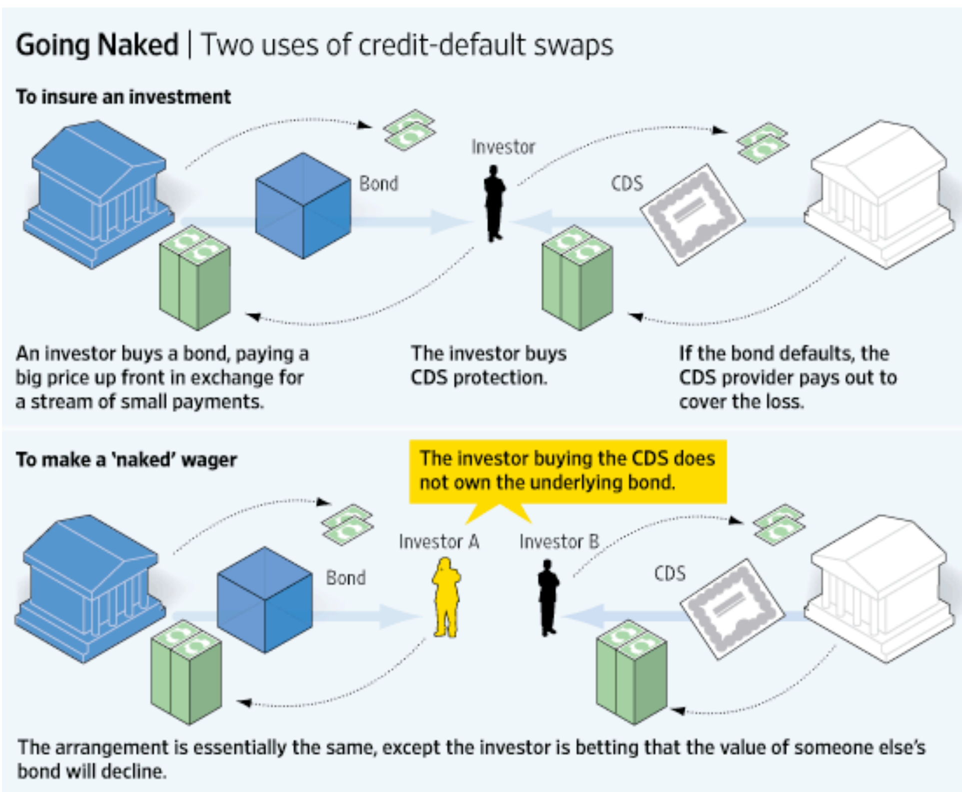
It is also unclear how "naked" purchases would be defined or how such a ban would be enforced.

The issue of a ban is expected to be discussed at a meeting of EU finance ministers in Brussels next week.

Any new law to ban the contracts would have to go through the EU's often convoluted law-making procedures, and commission officials said lawyers were still examining whether an outright ban would be legal.

The commission's Mr. Barroso said it was possible that European competition policy could be used to address the issue, allowing the commission to avoid the legislative process and enable it to act on its own.

However, such action could only follow an unusual and potentially lengthy inquiry into competitive practices in financial markets.



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