SPEECHES & TESTIMONY

CFTC Chairman J. Christopher Giancarlo Response to Bollettino

July 21, 2018

Congregation for the Doctrine of the Faith
Dicastery for Promoting Integral Human Development
Vatican City, Holy See
Attention: Secretary

Oeconomicae et Pecuniariae Quaestiones*: *Considerations for an Ethical Discernment Regarding Some Aspects of the Present Economic Financial System

Your Eminences,

The Congregation for the Doctrine of the Faith recently published the above-referenced *Bollettino* on economic and financial issues.[1] Building on the premise that "no area of human action" is outside ethical principles, the document lays out ethical foundations to govern economic and financial systems, including in the usage of derivatives (paragraph 26). We thank you for such a thought-provoking reflection.

We write to you as finance professionals striving to lead moral lives. One of us, Chairman J. Christopher Giancarlo, is a practicing Roman Catholic. We are also senior regulators of the world's largest derivatives markets and officials of the U.S. Commodity Futures Trading Commission (CFTC), the world's only derivatives-specific regulatory agency. The CFTC has overseen the U.S. exchange-traded derivatives markets for over 40 years. The agency is recognized for its principles-based regulatory framework and econometrically-driven analysis, as well as its depth of derivatives expertise and breadth of regulatory oversight.

We encourage market participants, particularly leaders in the business, academic, and government communities, to read and seriously consider the contents of the *Bollettino.* It is an important and caring commentary on modern finance. Yet, we also feel obligated to respond and defend derivatives and, in particular, credit default swaps, from various censures in the *Bollettino*. The *Bollettino's* criticisms have received outsized

attention in the popular press, despite the fact that the relevant section of the *Bollettino* is limited to a few paragraphs. Our response to these criticisms is made in the spirit of honest dialogue (so eloquently promoted and encouraged by Blessed Pope Paul VI) and we hope it will lead to greater discernment and understanding.

Social Utility of Derivatives

It is important firstly to recognize the social utility of derivatives.

Derivatives products allow the risks of variable production costs, such as the price of raw materials, energy, foreign currency and interest rates, to be transferred from those who cannot afford them to those who can. They serve the needs of society to help moderate price, supply and other commercial risks to free up capital for economic growth, job creation and prosperity.

For example, derivative products allow farmers and ranchers to hedge production costs and delivery prices. They are the reason shoppers enjoy stable prices, not only in the supermarket, but in all manner of consumer finance from auto loans to household purchases. Derivatives markets influence the price and availability of heating in homes, energy used in factories, interest rates borrowers pay on home mortgages, and returns workers earn on retirement savings. In short, derivatives stabilize the cost of day-to-day living.

Even those not actively participating in derivatives markets are affected by the prices generated by them. Commodity derivatives markets provide a critical source of information about future harvest prices. For example, a grain elevator uses the futures market as the basis for the price it offers local farmers at harvest. In return, farmers look to prices set on futures exchanges to determine for themselves whether they are getting fair value for their crop. Governments use that same information to make price projections, determine volatility measures, and make payouts on crop insurance.

Derivatives Impact on Most Vulnerable Populations

While often derided in the tabloid press as “risky,” derivatives – when used properly – are tools for efficient risk transfer and mitigation. This is especially so for the world’s poorest farming communities. A recent feature article[2] in the Financial Times about the price boom in Madagascar’s vanilla crop explains how the absence of a functioning market for vanilla futures underpins a violent boom and bust cycle in cash prices for the vanilla crop, exacerbating poverty and gang activity on the African island.

Four years ago, the United Nations Food and Agriculture Organization issued a report called “The State of Food Insecurity in the World.”[3] The report estimates that about 800 million people around the world today are undernourished – that is, roughly, one in nine of the world’s 7.2 billion people.[4] It is a staggering shortfall. Now, consider that the US Census Bureau estimates that there will be another two billion people on earth in the next 30 years.[5] Even if those projections are only half accurate, we will have another one billion people on earth by 2048. How will all of these people be fed?

Clearly, the world's agricultural exporting nations, including the United States, will play a big part in feeding the globe in the decades to come. Yet, they can only do so with the critical support of well-functioning financial and derivatives markets. Efficient and well-regulated cash and derivatives markets play a crucial role in controlling costs and facilitating return on capital to support essential investment in farming equipment and agricultural technology necessary to meet increased global food demand.

Markets for agricultural futures and other derivatives in the United States and elsewhere serve at least two critical roles in helping to feed the world's growing population. First, they allow markets to resolve imbalances dispassionately and efficiently by providing reliable and fair benchmarks for prices.[6] Second, they reduce price volatility in a resource-constrained world by removing the economic incentive to hoard physical supplies.[7] They allow farmers to quantify and transfer risks they want to avoid at a reasonable price to persons willing and able to hold that risk.[8] Provision of this risk protection to the farmer reduces earnings volatility and thus price volatility, benefiting all parties, including consumers who may never get involved in derivatives markets in the first place.[9]

In many ways, the greatest beneficiaries of global derivatives activities may well be the world's hungriest and most vulnerable. These are the people that Pope Francis has so powerfully advocated for by calling our attention to the "peripheries" of the world. They would certainly suffer the most from the extreme price volatility in basic food and energy commodities that would result if derivatives trading were to suddenly cease.

Credit Default Swaps (CDS): Definitions and Uses

It is important to understand how particular types of derivatives work, especially credit default swaps (CDS), which are the subject of analysis in the *Bollettino*.

A CDS "protection buyer" pays periodic "premiums" in exchange for a payout that is sufficient to make a bondholder whole in the event of a corporate default. For example, a CDS protection buyer might pay $1 per year in premiums against the default of $100 face amount of XYZ Corporation's bonds. Then, if XYZ Corporation defaults and the value of its bond falls to $40, the protection buyer would collect $60, so as to be made whole relative to the bond's $100 face amount.

A CDS "protection seller" takes the opposite position as the protection buyer. In exchange for collecting periodic premiums, the protection seller agrees to make payments that are sufficient to make bondholders whole in the event of a default.

Market participants use CDS in many ways. Here are some common examples:

- The owner of a corporate bond decides provisionally to protect itself from the credit risk of that particular corporation. Rather than sell the bond, the bondholder might buy CDS protection.

- An asset manager, insurance company, or pension fund that invests in corporate bonds decides to increase or decrease its exposure. Because corporate bonds have limited liquidity, however, the desired exposure is achieved immediately by selling or buying protection in CDS. Subsequently, over time, the CDS positions are replaced by corporate bond purchases or sales.

- A relatively small company is very dependent on its business dealings with a larger corporation. The small company buys CDS protection on the corporation to protect itself against the loss of business that would result if the corporation were to default.

- An investor would like protection against significant investments in a bank that is located in a financially challenged country. While there is no trading of CDS on the bank's credit, the bank and the country are likely to prosper or struggle together. The investor, therefore, buys CDS protection against the country's government.

- After conducting significant research on the business of a particular corporation, a hedge fund concludes that the corporation will struggle or even fail. The hedge fund buys CDS protection on that corporation so as to profit in the event of its decline.

The *Bollettino* would probably not object to scenarios 1) through 3), in which CDS are used to manage exposures to the credit market. The *Bollettino* certainly does seem to object, however, to scenario 5), in which a hedge fund uses its superior information to bet that a corporation will struggle or fail.

The position of the *Bollettino* with respect to scenario 4) is less clear. On the one hand, the investor is using CDS to hedge the exposure of its investments to the credit of the bank. On the other hand, the investor winds up taking a position that profits from the troubles of an entire nation.

It seems, therefore, that the *Bollettino*'s censure of CDS markets can be distilled down to three issues: information asymmetries, speculation, and profiting from the ruin of others. We now turn to each of these, in turn.

Information Asymmetries

The *Bollettino* views it as unethical to "take advantage of a lack of knowledge" of a trading counterpart.[10] Furthermore, "regulations must favor a complete transparency regarding whatever is traded in order to eliminate every form of injustice and inequality."[11]

These comments are not about stealing information and then trading, as in the case of a corporate or government insider that has access to and uses non-public information for private gain. Of course, all people of good will know that such unethical behavior is abhorrent. The *Bollettino* is referring here to information asymmetries that are "an inherent element of the system itself."[12]

The difficulty with broadly applying this ethical position to financial markets can be illustrated with an old joke. The owner of a car with engine trouble visits a mechanic. The mechanic opens the hood and carefully examines the engine. After some time, the mechanic takes out a hammer and bangs on one part of the engine. To the joy of the owner, the engine seems to be working as good as new.

"That will be $100," says the mechanic.

"$100?" asks the owner. "Just for one bang on the engine?"

"Oh, no," says the mechanic. "It's only $1 for the bang. But it's $99 for knowing where to bang."

The mechanic incurred great time and expense over years to gain expertise. Surely, he is entitled to earn a living from this investment of his time and experience. And the mechanic used that experience to examine the car and determine the cause of the problem. Certainly, ethical behavior in this scenario does not require the mechanic to explain the workings of the engine to the car owner and to demonstrate exactly where to bang before setting the price of the service. It must be ethical for the mechanic to serve his customer and earn a fee, even if the customer admittedly lacks knowledge of engine mechanics equal to that of the mechanic.

This joke is relevant to financial markets because the generation of information is costly. The economy at large benefits from high-quality information about the credit quality of corporations. As the *Bollettino* itself points out, "A healthy financial system… requires the maximum amount of information possible, so that every agent can protect his or her interests in full, and with complete freedom."[13]

But who is to become an expert in matters of economy and credit, collect raw data, analyze all of the relevant factors, and come to conclusions about the creditworthiness of a particular corporation or government? The answer, of course, is professionals, in the expectation of profiting thereby.

More precisely, while consensus in many societal contexts is achieved by reading, writing, and debate, consensus in financial markets is encapsulated in price and achieved by trading. Those who think the price too low, buy. Those who think it too high, sell.

From this perspective, the hedge fund in scenario 5), along, in fact, with all of the other market participants in the other scenarios, is generating information and trading. They are all hoping to earn superior financial returns but, in the process, also disseminate the information they have generated to the broader market.

Speculation

The *Bollettino* disparages “speculation,” but, like many others commentators, does not define the term. Stating, for example, that it is “morally illegitimate” to take “undue risk” with “predominantly… speculative purposes”[14] is not helpful as a practical guide to differentiating between acceptable and unacceptable activities.

Debate about the role of speculation is likely as old as markets themselves and will not be resolved here. Let the following, therefore, suffice:

First, whatever its definition, speculation contributes to the societally beneficial generation of information and the dissemination of that information to the public at large.

Second, whatever uses of CDS are considered appropriate and unobjectionable require a counterparty on the other side of the trade. A “speculator” that sells CDS protection, for example, may very well be the only facilitator of a pension fund’s purchase of CDS protection to hedge the credit risk of its bond holdings. Without such a speculator, the pension fund would be unable to hedge and acquire the bond in the first place, which would thwart economic activity.

Profiting from the Ruin of Others

The *Bollettino* objects to the use of CDS in scenario 5), which “permit[s] gambling at the risk of the bankruptcy of a third party... creates a unique case in which persons start to nurture interests for the ruin of other economic entities… [and] shapes an event… of a kind of economic cannibalism.”[15]

But profiting from the misfortune of others is not at all unique to the case of “naked” buying of CDS protection, i.e., buying protection on a corporation’s bonds without holding any of those bonds.

A particularly unobjectionable example is an annuity. In an annuity contract, an insurance company accepts money from a customer in exchange for making payments until the customer’s death. Customers like these contracts because they can safeguard a particular income even if they live a lot longer than expected. Nevertheless, the insurance company does make a greater profit if the customer dies sooner rather than later.

Another very common example of profiting from the misfortune of others is when investors “short” stocks or bonds, that is, sell assets first and re-purchase them later, in the hopes of price declines.

Short sellers of stock and bonds are often subject to the same sort of opprobrium as naked buyers of CDS protection. But discouraging short positions is counterproductive in the context of information generation: allowing people without pre-existing positions to buy but not to sell skews the voting of the marketplace toward higher, though very possibly unjustified valuations.

The *Bollettino* reserves special reproach for naked purchases of protections on sovereign nations, that is, for “gambling” that a nation will default. Such purchases are considered “extremely immoral actions,” from which “can derive enormous damage for entire nations and millions of families,” and which call for sanctions of “maximum severity.”[16]

The problem with this posture is that governments actually benefit from the availability of CDS on their sovereign securities. Recent research has shown that the initiation of CDS trading on sovereign bonds lowers countries’ cost of debt and increases the information efficiency of their bond markets. In fact, the greatest reductions in debt cost are enjoyed by the countries with the highest risks of default[17] hedged through the use of sovereign CDS. Without such availability, bond holders would demand that governments pay higher interest payments to offset the additional risk to bondholders that in a crisis the only participants in CDS markets would be limited to other sovereign bondholders.

Furthermore, it must be acknowledged that national governments do not always conduct their financial affairs in the best interests of their people or with the highest degree of fiscal competence or integrity. The prices of government bonds, or of CDS on sovereign nations, are an important check on poor fiscal management. Removing this market check on government policy might very well delay and worsen the day of reckoning.

Conclusion

“Oeconomicae et Pecuniariae Quaestiones” is a document worthy of consideration by all participants in financial markets who strive to lead a moral life. In a very small corner of the very large issues raised by the document, we have argued that derivatives help stabilize the price of global commodities and financial rates in a manner that is particularly beneficial to the world’s poor. In particular, we maintain that CDS have an important and respectable place in today’s financial system. CDS markets generate and disseminate valuable information about credit to the broader economy. And market participants use CDS to hedge their business risks, which, in turn, allows them to expand production, provide additional services, or increase lending.

We do not claim that the CDS market is free from both economic and ethical challenges. We agree with the *Bollettino* in being skeptical of overly complex derivative products, like CDS tranches on mortgage-backed securities, which traded in great volume in the run-up to the 2007-2009 financial crisis. And we also agree that buyers of CDS protection, who stand to gain from defaults, must not be allowed to conspire to cause those same defaults or make them more likely. Such activity has recently drawn our regulatory scrutiny and censure.[18]

As officers of the CFTC, we are committed to policing CDS markets, along with all other derivatives markets, with the view, in the words of the *Bollettino*, of advancing liberty, truth, and justice.

We thank you for your consideration of the points we have set out in this letter. We would be very pleased for the opportunity to meet with members of the Dicastery as convenient to discuss these very important matters. We often travel to Europe for regulatory meetings so a quick stopover to your office would be entirely possible.

Most respectfully yours,

J. Christopher Giancarlo, Chairman

Bruce Tuckman, Chief Economist

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[1] "Oeconomicae et pecuniariae quaestiones: Considerations for an ethical discernment regarding some aspects of the present economic-financial system," Holy See Press Office, May 17, 2018 ("Bollettino").

[2] David Pilling, The Real Price of Madagascar's Vanilla Boom, The Financial Times, June 5, 2018, at: https://www.ft.com/content/02042190-65bc-11e8-90c2-9563a0613e56

[3] Food and Agriculture Organization of the United Nations, International Fund for Agricultural Development, World Food Programme, The State of Food Insecurity in the World 2014. Strengthening the enabling environment for food security and nutrition, 2014, available at http://www.fao.org/publications/sofi/en/.

[4] Id. At 8.

[5] United States Census Bureau, International Data Base World Population: 1950-2050, available at http://www.census.gov/population/international/data/idb/worldpopgraph.php.

[6] J.P. Morgan, Commodity Markets Outlook and Strategy: Nine billion bellies: Managing food, water, land, and air to 2050, at 12, Feb. 25, 2013, available at https://markets.jpmorgan.com/research/EmailPubServlet?action=open&hashcode=-macg0hs&doc=GPS-1061241-0.pdf.

[7] Id.

[8] J.P. Morgan, Is there a food crisis and why? Understanding the role that market-based solutions might play in addressing global hunger, at 4, Dec. 23, 2010, available at https://www.jpmorgan.com/cm/BlobServer/VoP_food_crisis_sept2010.pdf?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1158616602825&blobheader=application%2Fpd.

[9] Id.

[10] Bollettino, p. 5.

[11] bid., p. 8.

[12] Ibid., p. 5.

[13] Ibid., p. 8.

[14] Ibid., p. 6.

[15] Ibid., p. 10.

[16] Ibid., pp. 10-11.

[17] Ismailescu, Iuliana, and Phillips, Blake, 2015, “Credit Default Swaps and the Market for Sovereign Debt,” Journal of Banking and Finance, Elsevier, vol. 52(C), pages 43-61.

[18] See “Statement on Manufactured Credit Events by CFTC Divisions of Clearing and Risk, Market Oversight, and Swap Dealer and Intermediary Oversight,” April 24, 2018, at: https://www.cftc.gov/PressRoom/SpeechesTestimony/divisionsstatement042418

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