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A Secretive Banking Elite Rules Trading in Derivatives

By LOUISE STORY

On the third Wednesday of every month, the nine members of an elite Wall Street society gather in Midtown Manhattan.

The men share a common goal: to protect the interests of big banks in the vast market for derivatives, one of the most profitable — and controversial — fields in finance. They also share a common secret: The details of their meetings, even their identities, have been strictly confidential.

Drawn from giants like JPMorgan Chase, Goldman Sachs and Morgan Stanley, the bankers form a powerful committee that helps oversee trading in derivatives, instruments which, like insurance, are used to hedge risk.

In theory, this group exists to safeguard the integrity of the multitrillion-dollar market. In practice, it also defends the dominance of the big banks.

The banks in this group, which is affiliated with a new derivatives clearinghouse, have fought to block other banks from entering the market, and they are also trying to thwart efforts to make full information on prices and fees freely available.

Banks' influence over this market, and over clearinghouses like the one this select group advises, has costly implications for businesses large and small, like Dan Singer's home heating-oil company in Westchester County, north of New York City.

This fall, many of Mr. Singer's customers purchased fixed-rate plans to lock in winter heating oil at around $3 a gallon. While that price was above the prevailing $2.80 a gallon then, the contracts will protect homeowners if bitterly cold weather pushes the price higher.

But Mr. Singer wonders if his company, Robison Oil, should be getting a better deal. He uses derivatives like swaps and options to create his fixed plans. But he has no idea how much lower his prices — and his customers' prices — could be, he says, because banks don't disclose fees associated with the derivatives.

"At the end of the day, I don't know if I got a fair price, or what they're charging me," Mr. Singer said.

Derivatives shift risk from one party to another, and they offer many benefits, like enabling Mr. Singer to sell his fixed plans without having to bear all the risk that oil prices could suddenly rise. Derivatives are also big business on Wall Street. Banks collect many billions of dollars annually in undisclosed fees associated with these instruments — an amount that almost certainly would be lower if there were more competition and transparent prices.

Just how much derivatives trading costs ordinary Americans is uncertain. The size and reach of this market has grown rapidly over the past two decades. Pension funds today use derivatives to hedge investments. States and cities use them to try to hold down borrowing costs. Airlines use them to secure steady fuel prices. Food companies use them to lock in prices of commodities like wheat or beef.

The marketplace as it functions now "adds up to higher costs to all Americans," said Gary Gensler, the chairman of the Commodity Futures Trading Commission, which regulates most derivatives. More oversight of the banks in this market is needed, he said.

But big banks influence the rules governing derivatives through a variety of industry groups. The banks' latest point of influence are clearinghouses like ICE Trust, which holds the monthly meetings with the nine bankers in New York.

Under the Dodd-Frank financial overhaul, many derivatives will be traded via such clearinghouses. Mr. Gensler wants to lessen banks' control over these new institutions. But Republican lawmakers, many of whom received large campaign contributions from bankers who want to influence how the derivatives rules are written, say they plan to push back against much of the coming reform. On Thursday, the commission canceled a vote over a proposal to make prices more transparent, raising speculation that Mr. Gensler did not have enough support from his fellow commissioners.

The Department of Justice is looking into derivatives, too. The department's antitrust unit is actively investigating "the possibility of anticompetitive practices in the credit derivatives clearing, trading and information services industries," according to a department spokeswoman.

Indeed, the derivatives market today reminds some experts of the Nasdaq stock market in the 1990s. Back then, the Justice Department discovered that Nasdaq market makers were secretly colluding to protect their own profits. Following that scandal, reforms and electronic trading systems cut Nasdaq stock trading costs to 1/20th of their former level — an enormous savings for investors.

“When you limit participation in the governance of an entity to a few like-minded institutions or individuals who have an interest in keeping competitors out, you have the potential for bad things to happen. It’s antitrust 101,” said Robert E. Litan, who helped oversee the Justice Department’s Nasdaq investigation as deputy assistant attorney general and is now a fellow at the Kauffman Foundation. “The history of derivatives trading is it has grown up as a very concentrated industry, and old habits are hard to break.”

Representatives from the nine banks that dominate the market declined to comment on the Department of Justice investigation.

Clearing involves keeping track of trades and providing a central repository for money backing those wagers. A spokeswoman for Deutsche Bank, which is among the most influential of the group, said this system will reduce the risks in the market. She said that Deutsche is focused on ensuring this process is put in place without disrupting the marketplace.

The Deutsche spokeswoman also said the banks’ role in this process has been a success, saying in a statement that the effort “is one of the best examples of public-private partnerships.”

Established, But Can’t Get In

The Bank of New York Mellon’s origins go back to 1784, when it was founded by Alexander Hamilton. Today, it provides administrative services on more than $23 trillion of institutional money.

Recently, the bank has been seeking to enter the inner circle of the derivatives market, but so far, it has been rebuffed.

Bank of New York officials say they have been thwarted by competitors who control important committees at the new clearinghouses, which were set up in the wake of the financial crisis.

Bank of New York Mellon has been trying to become a so-called clearing member since early this year. But three of the four main clearinghouses told the bank that its derivatives operation has too little capital, and thus potentially poses too much risk to the overall market.

The bank dismisses that explanation as absurd. “We are not a nobody,” said Sanjay Kannambadi, chief executive of BNY Mellon Clearing, a subsidiary created to get into the business. “But we don’t qualify. We certainly think that’s kind of crazy.”

The real reason the bank is being shut out, he said, is that rivals want to preserve their profit margins, and they are the ones who helped write the membership rules.

Mr. Kannambadi said Bank of New York’s clients asked it to enter the derivatives business because they believe they are being charged too much by big banks. Its entry could lower fees. Others that have yet to gain full entry to the derivatives trading club are the State Street Corporation, and small brokerage firms like MF Global and Newedge.

The criteria seem arbitrary, said Marcus Katz, a senior vice president at Newedge, which is owned by two big French banks.

“It appears that the membership criteria were set so that a certain group of market participants could meet that, and everyone else would have to jump through hoops,” Mr. Katz said.

The one new derivatives clearinghouse that has welcomed Newedge, Bank of New York and the others — Nasdaq — has been avoided by the big derivatives banks.

Only the Insiders Know

How did big banks come to have such influence that they can decide who can compete with them?

Ironically, this development grew in part out of worries during the height of the financial crisis in 2008. A major concern during the meltdown was that no one — not even government regulators — fully understood the size and interconnections of the derivatives market, especially the market in credit default swaps, which insure against defaults of companies or mortgages bonds. The panic led to the need to bail out the American International Group, for instance, which had C.D.S. contracts with many large banks.

In the midst of the turmoil, regulators ordered banks to speed up plans — long in the making — to set up a clearinghouse to handle derivatives trading. The intent was to reduce risk and increase stability in the market.

Two established exchanges that trade commodities and futures, the InterContinentalExchange, or

ICE, and the Chicago Mercantile Exchange, set up clearinghouses, and, so did Nasdaq.

Each of these new clearinghouses had to persuade big banks to join their efforts, and they doled out membership on their risk committees, which is where trading rules are written, as an incentive.

None of the three clearinghouses would divulge the members of their risk committees when asked by a reporter. But two people with direct knowledge of ICE's committee said the bank members are: Thomas J. Benison of JPMorgan Chase & Company; James J. Hill of Morgan Stanley; Athanassios Diplas of Deutsche Bank; Paul Hamill of UBS; Paul Mitrokostas of Barclays; Andy Hubbard of Credit Suisse; Oliver Frankel of Goldman Sachs; Ali Balali of Bank of America; and Biswarup Chatterjee of Citigroup.

Through representatives, these bankers declined to discuss the committee or the derivatives market. Some of the spokesmen noted that the bankers have expertise that helps the clearinghouse.

Many of these same people hold influential positions at other clearinghouses, or on committees at the powerful International Swaps and Derivatives Association, which helps govern the market.

Critics have called these banks the "derivatives dealers club," and they warn that the club is unlikely to give up ground easily.

"The revenue these dealers make on derivatives is very large and so the incentive they have to protect those revenues is extremely large," said Darrell Duffie, a professor at the Graduate School of Business at Stanford University, who studied the derivatives market earlier this year with Federal Reserve researchers. "It will be hard for the dealers to keep their market share if everybody who can prove their creditworthiness is allowed into the clearinghouses. So they are making arguments that others shouldn't be allowed in."

Perhaps no business in finance is as profitable today as derivatives. Not making loans. Not offering credit cards. Not advising on mergers and acquisitions. Not managing money for the wealthy.

The precise amount that banks make trading derivatives isn't known, but there is anecdotal evidence of their profitability. Former bank traders who spoke on condition of anonymity because of confidentiality agreements with their former employers said their banks typically earned $25,000 for providing $25 million of insurance against the risk that a corporation might default on its debt via the swaps market. These traders turn over millions of dollars in these trades every day, and credit default swaps are just one of many kinds of derivatives.

The secrecy surrounding derivatives trading is a key factor enabling banks to make such large profits.

If an investor trades shares of Google or Coca-Cola or any other company on a stock exchange, the price — and the commission, or fee — are known. Electronic trading has made this information available to anyone with a computer, while also increasing competition — and sharply lowering the cost of trading. Even corporate bonds have become more transparent recently. Trading costs dropped there almost immediately after prices became more visible in 2002.

Not so with derivatives. For many, there is no central exchange, like the New York Stock Exchange or Nasdaq, where the prices of derivatives are listed. Instead, when a company or an investor wants to buy a derivative contract for, say, oil or wheat or securitized mortgages, an order is placed with a trader at a bank. The trader matches that order with someone selling the same type of derivative.

Banks explain that many derivatives trades have to work this way because they are often customized, unlike shares of stock. One share of Google is the same as any other. But the terms of an oil derivatives contract can vary greatly.

And the profits on most derivatives are masked. In most cases, buyers are told only what they have to pay for the derivative contract, say $25 million. That amount is more than the seller gets, but how much more — $5,000, $25,000 or $50,000 more — is unknown. That's because the seller also is told only the amount he will receive. The difference between the two is the bank's fee and profit. So, the bigger the difference, the better for the bank — and the worse for the customers.

It would be like a real estate agent selling a house, but the buyer knowing only what he paid and the seller knowing only what he received. The agent would pocket the difference as his fee, rather than disclose it. Moreover, only the real estate agent — and neither buyer nor seller — would have easy access to the prices paid recently for other homes on the same block.

An Electronic Exchange?

Two years ago, Kenneth C. Griffin, owner of the giant hedge fund Citadel Group, which is based in Chicago, proposed open pricing for commonly traded derivatives, by quoting their prices electronically. Citadel oversees $11 billion in assets, so saving even a few percentage points in costs on each trade could add up to tens or even hundreds of millions of dollars a year.

But Mr. Griffin's proposal for an electronic exchange quickly ran into opposition, and what happened is a window into how banks have fiercely fought competition and open pricing. To get a transparent exchange going, Citadel offered the use of its technological prowess for a joint venture with the Chicago Mercantile Exchange, which is best-known as a trading outpost for contracts on commodities like coffee and cotton. The goal was to set up a clearinghouse as well as an electronic trading system that would display prices for credit default swaps.

Big banks that handle most derivatives trades, including Citadel's, didn't like Citadel's idea. Electronic trading might connect customers directly with each other, cutting out the banks as middlemen.

So the banks responded in the fall of 2008 by pairing with ICE, one of the Chicago Mercantile Exchange's rivals, which was setting up its own clearinghouse. The banks attached a number of conditions on that partnership, which came in the form of a merger between ICE's clearinghouse and a nascent clearinghouse that the banks were establishing. These conditions gave the banks significant power at ICE's clearinghouse, according to two people with knowledge of the deal. For instance, the banks insisted that ICE install the chief executive of their effort as the head of the joint effort. That executive, Dirk Pruis, left after about a year and now works at Goldman Sachs. Through a spokesman, he declined to comment.

The banks also refused to allow the deal with ICE to close until the clearinghouse's rulebook was established, with provisions in the banks' favor. Key among those were the membership rules, which required members to hold large amounts of capital in derivatives units, a condition that was prohibitive even for some large banks like the Bank of New York.

The banks also required ICE to provide market data exclusively to Markit, a little-known company that plays a pivotal role in derivatives. Backed by Goldman, JPMorgan and several other banks, Markit provides crucial information about derivatives, like prices.

Kevin Gould, who is the president of Markit and was involved in the clearinghouse merger, said the banks were simply being prudent and wanted rules that protected the market and themselves.

"The one thing I know the banks are concerned about is their risk capital," he said. "You really are going to get some comfort that the way the entity operates isn't going to put you at undue risk.”

Even though the banks were working with ICE, Citadel and the C.M.E. continued to move forward with their exchange. They, too, needed to work with Markit, because it owns the rights to certain derivatives indexes. But Markit put them in a tough spot by basically insisting that every trade involve at least one bank, since the banks are the main parties that have licenses with Markit.

This demand from Markit effectively secured a permanent role for the big derivatives banks since Citadel and the C.M.E. could not move forward without Markit’s agreement. And so, essentially boxed in, they agreed to the terms, according to the two people with knowledge of the matter. (A spokesman for C.M.E. said last week that the exchange did not cave to Markit’s terms.)

Still, even after that deal was complete, the Chicago Mercantile Exchange soon had second thoughts about working with Citadel and about introducing electronic screens at all. The C.M.E. backed out of the deal in mid-2009, ending Mr. Griffin’s dream of a new, electronic trading system.

With Citadel out of the picture, the banks agreed to join the Chicago Mercantile Exchange’s clearinghouse effort. The exchange set up a risk committee that, like ICE’s committee, was mainly populated by bankers.

It remains unclear why the C.M.E. ended its electronic trading initiative. Two people with knowledge of the Chicago Mercantile Exchange’s clearinghouse said the banks refused to get involved unless the exchange dropped Citadel and the entire plan for electronic trading.

Kim Taylor, the president of Chicago Mercantile Exchange’s clearing division, said “the market” simply wasn’t interested in Mr. Griffin’s idea.

Critics now say the banks have an edge because they have had early control of the new clearinghouses’ risk committees. Ms. Taylor at the Chicago Mercantile Exchange said the people on those committees are supposed to look out for the interest of the broad market, rather than their own narrow interests. She likened the banks’ role to that of Washington lawmakers who look out for the interests of the nation, not just their constituencies.

“It’s not like the sort of representation where if I’m elected to be the representative from the state of Illinois, I go there to represent the state of Illinois,” Ms. Taylor said in an interview.

Officials at ICE, meantime, said they solicit views from customers through a committee that is separate from the bank-dominated risk committee.

“We spent and we still continue to spend a lot of time on thinking about governance,” said Peter Barsoom, the chief operating officer of ICE Trust. “We want to be sure that we have all the right stakeholders appropriately represented.”

Mr. Griffin said last week that customers have so far paid the price for not yet having electronic trading. He puts the toll, by a rough estimate, in the tens of billions of dollars, saying that electronic trading would remove much of this “economic rent the dealers enjoy from a market that is so opaque.”

“It’s a stunning amount of money,” Mr. Griffin said. “The key players today in the derivatives market are very apprehensive about whether or not they will be winners or losers as we move towards more transparent, fairer markets, and since they’re not sure if they’ll be winners or losers, their basic instinct is to resist change.”

In, Out and Around Henhouse

The result of the maneuvering of the past couple years is that big banks dominate the risk committees of not one, but two of the most prominent new clearinghouses in the United States.

That puts them in a pivotal position to determine how derivatives are traded.

Under the Dodd-Frank bill, the clearinghouses were given broad authority. The risk committees there will help decide what prices will be charged for clearing trades, on top of fees banks collect for matching buyers and sellers, and how much money customers must put up as collateral to cover potential losses.

Perhaps more important, the risk committees will recommend which derivatives should be handled through clearinghouses, and which should be exempt.

Regulators will have the final say. But banks, which lobbied heavily to limit derivatives regulation in the Dodd-Frank bill, are likely to argue that few types of derivatives should have to go through clearinghouses. Critics contend that the bankers will try to keep many types of derivatives away from the clearinghouses, since clearinghouses represent a step towards broad electronic trading that could decimate profits.

The banks already have a head start. Even a newly proposed rule to limit the banks’ influence over clearing allows them to retain majorities on risk committees. It remains unclear whether regulators creating the new rules — on topics like transparency and possible electronic trading — will drastically change derivatives trading, or leave the bankers with great control.

One former regulator warned against deferring to the banks. Theo Lubke, who until this fall oversaw the derivatives reforms at the Federal Reserve Bank of New York, said banks do not always think of the market as a whole as they help write rules.

"Fundamentally, the banks are not good at self-regulation," Mr. Lubke said in a panel last March at Columbia University. "That's not their expertise, that's not their primary interest."