

December 12, 2010

A Secretive Banking Elite Rules Trading in Derivatives

The New York Times

Published: Sunday, 12 Dec 2010 | 9:06 AM ET

This is an abridged version, for the full story visit
<http://www.nytimes.com/2010/12/12/business/12advantage.html>

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.

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. Mr. Singer 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. ***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.***

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](#).

"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](#). 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. 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. 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.