

Background

No. 2262
April 23, 2009



Published by The Heritage Foundation

Credit Derivatives: Market Solutions to the Market Crisis

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As Congress and the Obama Administration consider changes in financial market regulation, much attention is focused on once obscure and still poorly understood financial instruments known as credit default swaps (CDSs). The House Agriculture Committee has approved legislation that would restrict who may own CDSs and where they may be traded. The Obama Administration has proposed requiring that CDS contracts be settled through clearinghouses rather than directly between the contracting parties.

Meanwhile, in the real world outside of Washington, the institutions that make and manage CDS markets are completing a series of changes that will make global credit markets more transparent, efficient, and stable—everything regulation promises but rarely delivers. On March 9, a new clearinghouse began processing CDS trades. On April 8, CDS trading conventions were transformed in a “big bang” arranged by the International Swaps and Derivatives Association (ISDA), the trade association of derivatives dealers.

In combination, these developments make the CDS market safer, more transparent, and more liquid. These private-sector changes will deliver or facilitate most of the benefits sought through proposed regulation, but in a way that will preserve the vitality and utility of a critical national and international credit market.

These reforms occurred with a nudge from regulators, but the private-sector execution and likely success of these reforms is a model for further reform of

Talking Points

- Contrary to largely misinformed criticisms, credit default swaps (CDSs) play an important and productive role in U.S. and international financial markets.
- Market participants have recently made significant changes to improve the CDS market.
- An overly complex regulatory structure actually hindered improvements in the CDS market. Sound regulation interacts with markets rather than insisting that markets conform to preconceived government categories and jurisdictions.
- The Obama Administration and Congress should encourage continued market improvements rather than imposing restrictions or significant new regulations on CDSs. Market participants are able to develop innovative solutions and implement them more quickly than regulators can.
- To the extent that new regulation is deemed necessary, policymakers should focus on rationalizing the regulatory framework rather than on simply imposing new rules or creating new agencies on top of the existing ineffective structure.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Regulation/bg2262.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
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financial regulation. CDS market developments provide three important regulatory lessons that can be applied across financial markets.

1. **Policymakers should encourage market reforms for market problems.** Markets themselves will often correct deficiencies far more rapidly than regulators. This does not mean that regulation has no place; it means that regulators can often act most effectively by encouraging private parties to devise market solutions to market problems whenever possible rather than by dictating nonmarket solutions.
2. **Policymakers should consider how existing regulation contributed to market deficiencies.** Instead of automatically assuming that more regulation is required, policymakers should carefully review the causes of market disruptions. In many cases, rationalizing existing regulations will contribute more to market stability than new rules or regulatory bodies can. In fact, layering new regulations and agencies on the outdated and obviously failed structure that exists today could lead to further market dysfunction. Overregulation is as dangerous as underregulation, but overregulation is harder to identify and fix.
3. **Rules should be flexible to allow for and react to changes in markets.** Markets evolve. They cannot be created or run by government, although they are shaped by regulation. The incentive effects of regulation are too often ignored as a tool and byproduct of regulation.

Congress should facilitate the ongoing market and regulatory evolution of credit derivatives markets rather than reflexively imposing regulation or insisting that markets conform to government jurisdictional categories.

Credit Derivatives

Derivatives are financial instruments that have a value based on the price of something else. Two common forms of derivatives are futures and options. Using these products, a farmer can plant

grain in June and know the price that he will receive for it in September because he has already sold the crop in the futures market. Similarly, an airline can sell tickets six months in advance and know its costs because it has used an option contract to limit the price it will pay for jet fuel.

Financial derivatives, which have values related to underlying financial exchanges, are similarly useful. For instance, investors can “swap” variable payments for fixed income without selling the underlying asset. One side of the transaction values predictable payments; the other is willing to bear the risk in return for the profit potential of variations in the income stream.

Credit default swaps are financial derivatives that operate like insurance on bonds or other debt. One party pays a periodic premium, and the other party promises to make good on the debt in the event of a “credit event,” such as missed payments or bankruptcy. This type of transaction is valuable because it can reduce the risk faced by bondholders or other creditors.

Credit Default Swaps

Credit default swaps were developed as a way for lenders to transfer the risk that a loan would not be repaid without transferring the underlying loan. Banks can find it difficult or impossible to sell loans because of restrictions in loan agreements, concern for a larger relationship with the borrower, or the simple lack of a market for individual loans. CDSs addressed these difficulties by preserving the original loan while transferring the associated repayment risk. CDSs were also used to facilitate the packaging of multiple loans into securities that are more readily marketable than individual loans.¹

A principal reason for the rapid growth in CDSs was the adoption of mark-to-market accounting and capital requirements in the United States and internationally through the Basel bank capital requirements. Under historic value accounting, a bank or other regulated entity could buy a bond, earn interest, and count the principal amount paid for the bond as regulatory capital.

1. J.P. Morgan, “The J.P. Morgan Guide to Credit Derivatives,” at http://www.investinginbonds.com/assets/files/Intro_to_Credit_Derivatives.pdf (April 13, 2009).

However, bond prices fluctuate in response to changes in interest rates and changes in the borrower's financial status. Under mark-to-market accounting, these fluctuations must be recognized on a continuing basis. A bondholder might be required to post additional capital or suffer a downgrade in its own credit, even without any real loss on the bonds. This caused a number of bond buyers to switch from traditional bond insurance, which covers losses but is not marked to market, to CDSs, which are marked to market.² Because CDS values vary inversely with the value of the reference entity's bonds, banks can use CDSs to smooth out fluctuations in their regulatory capital accounts.

The use of CDSs also grew rapidly because they were adaptable for a variety of uses. The market grew quickly to include swaps on a corporation's total debt ("single names") and on broad indexes of corporate debt and other types of securities.

Banks and bondholders are not the only creditors in the marketplace. Landlords are creditors to tenants. Suppliers are creditors to customers. A landlord can use CDSs to protect against the risk of a tenant's failing to pay rent. Swaps have been written on individual leases, but a landlord can also buy a swap on a tenant's overall debt or even on a class of debt, such as that of retail merchants, and secure a reasonable hedge against a tenant's default. Companies entering into long-term supply contracts with business partners can similarly protect themselves against a partner's failure by using CDSs.

CDSs are also used increasingly to assess credit-worthiness and credit risk. Bond rating agencies have been widely discredited in the wake of the market meltdown. CDSs provide a market measure of a firm's credit risk. Moreover, a creditor who wishes to do so can actually buy a CDS to hedge risk. A bond rating provides no such guarantee.

Did Credit Derivatives Cause the Market Crisis?

Some commentators have suggested that CDSs were a cause of the recent market crisis. Dissecting these claims can be difficult because the criticisms are misinformed or inconsistent. Warren Buffett famously described CDSs as "weapons of financial mass destruction" in Berkshire Hathaway's 2002 annual report.³ However, Buffett recently admitted that his company has sold at least 251 derivative contracts with a total face value of more than \$14 billion. Buffett says he plans to continue selling CDSs because "the odds strongly favor making money."⁴

Specific criticisms of CDSs fall into four categories:

- The size of the CDS market threatens the economy,
- CDSs are used to manipulate markets,
- CDSs created excessive risk, and
- CDSs contributed to the freeze-up in credit markets.

Some of these criticisms are simply misinformed. In other cases, reforms in CDS markets, such those recently implemented in the private sector, rather than more regulation is the most appropriate solution.

Market Size. New York Insurance Commissioner Eric Dinallo, one of the loudest critics of CDSs, argued that the size of the CDS market was a threat to the economy by comparing the face value of outstanding CDS contracts with the size of the U.S. private-sector debt: about a 4:1 ratio.⁵ Regrettably, Dinallo, who ought to know better, fundamentally misrepresents the CDS market. For one thing, the CDS market encompasses European and international corporate debt and mortgage securities, not just U.S. bonds, and includes sovereign debt of the

2. MBIA Insurance Corporation, "An Introduction to the Impact of 'Mark to Market' Accounting on MBIA and Financial Guarantors," at <http://www.mbia.com/investor/publications/MarktoMarketPrimer.pdf> (April 13, 2009).
3. Warren Buffett, "Warren Buffet [sic] on Derivatives," edited excerpts from 2002 Berkshire Hathaway annual report, at <http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf> (April 13, 2009).
4. Betty Liu and Erik Holm, "Buffett Affirms Derivative Sale, Says He'll Do More," Bloomberg.com, March 12, 2009, at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=awHnCLbxqUcs> (April 13, 2009).
5. Eric Dinallo, testimony before Committee on Agriculture, U.S. House of Representatives, November 20, 2008, p. 3, at <http://agriculture.house.gov/testimony/110/h91120/Dinallo.pdf> (April 13, 2009).

U.S. and other nations. The week Dinallo made his charge, the largest individual debtor named in outstanding CDS contracts was the Republic of Italy,⁶ not a U.S. corporation.

Moreover, the face value of CDSs is deceptive because the over-the-counter CDS market is largely bilateral. When participants want to change their CDS investment mix, they usually write new contracts rather than buy, sell, or cancel existing contracts. For instance, a bank might sell \$100 million in protection on a particular type of debt and then later buy \$90 million in protection on the same debt to hedge its position. The bank would report \$190 million in outstanding contracts even though its net exposure was only \$10 million.

To the extent that the high “notional value” is perceived as a problem, market participants have already begun to address the issue through a series of “compression” efforts by matching and eliminating offsetting trades within a related series. The ongoing migration of trades to the CDS clearinghouse will greatly facilitate this effort. The need to write offsetting trades to change market positions will be further reduced by the “big bang” convention changes, which will make CDSs more standardized and more readily tradable.

In combination, these market developments are likely to reduce the notional-to-net ratio significantly.

Market Manipulation. Richard Fuld, former chief executive officer of Lehman Brothers, fingered CDS sales as partly responsible for his firm’s failure.⁷ Some evidence indicates that non-CDS transactions—“short” sales of stock—may have contributed to Lehman’s failure.⁸ However, CDSs are related to the debt of a corporation, not its equity (stock). Moreover, CDS contracts are often settled for cash rather than through an exchange of debt securities (physical settlement), making it difficult to posit a causal link between CDS trades and the company’s failure.

Of course, CDS trading reflects investors’ views of a company’s health, but this is a measure of sentiment, not a cause of corporate ills. The effect of market psychology on prices is hardly unique to the CDS market. Blaming CDSs for corporate debt problems is like blaming the thermometer for the temperature.

To the extent that market manipulation does occur—through CDSs or other mechanisms—it is already illegal, both as common-law fraud and under federal securities statutes. Processing trades through a central clearinghouse that is regulated by the Federal Reserve and the Securities and Exchange Commission (SEC) will make it easier for regulators to monitor and review trading activity if an investigation is necessary.

Risk Allocation. Insurance giant AIG clearly misunderstood and misallocated risks associated with its CDS trades. However, the miscalculation was related to the mortgage-backed securities that AIG guaranteed through its trades. Like many mortgage investors, AIG believed that home prices were unlikely to decline and that any declines would be “uncorrelated” (limited to discrete areas rather than affecting the entire housing market at once).

CDS trading practices that prevailed until recently facilitated AIG in taking risky bets on the housing market.

- *First*, prices in the over-the-counter CDS market were not readily available, giving AIG and similarly situated parties little external feedback about appropriate pricing.
- *Second*, the prevailing margin practices allowed AIG to write CDS contracts without posting margins or reserves against losses.

Once more, recent market developments have begun to address these problems. New CDS trading conventions include standard contract dates, uniform pricing methods, and improved resolution proce-

6. Depository Trust and Clearing Corporation, “DTCC Deriv/SERV Trade Information Warehouse Reports,” Web page, at <http://www.dtcc.com/products/derivserv/data> (April 13, 2009).

7. Richard S. Fuld, Jr., statement before Committee on Oversight and Government Reform, U.S. House of Representatives, October 8, 2008, p. 8, at <http://oversight.house.gov/documents/20081006125839.pdf> (April 13, 2009).

8. Gary Matsumoto, “Naked Short Sales Hint Fraud in Bringing Down Lehman,” Bloomberg.com, March 19, 2009, at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aB1j1qmFOTCA> (April 13, 2009).

dures. These changes will make the market broader and more liquid, providing better pricing information. Central clearinghouses will collect and enforce margin requirements and scrutinize market positions. Because each clearinghouse member ultimately stands behind trades made through it, members will monitor trading positions to prevent excessive risk concentrations or insufficient margin reserves.

Credit Contraction. “Counterparty risk”—the possibility that a contractual partner will fail to pay what is owed—is a significant concern in any financial transaction, including garden-variety loans and bank deposits. The risk that a party may not pay cannot be eliminated: CDSs allow the risk to be transferred, but transferring a risk does not magnify it.

In September 2008, world financial markets experienced an historic credit freeze. The contraction was not limited to CDS markets. For instance, investors withdrew \$210 billion from money market funds in a two-day period after one fund failed due to overexposure to Lehman Brothers debt.⁹ Critics charge that uncertainty about CDS obligations combined with the long chains of obligations involved in many CDS trades may have triggered or intensified this credit crisis.¹⁰

Compared to public markets (such as stock markets), the over-the-counter CDS market was opaque because pricing and volume information was not readily available, less efficient because of the large volume of contracts and relatively slow settlement process, and more subject to counterparty risk. Large numbers of CDS contracts were written on mortgage-related debt. When the housing market decline triggered claims, CDS market imperfections arguably contributed to three problems.

- Some companies, such as AIG, mispriced products and underestimated risks and had difficulty honoring contracts that they had written.

- The complex, opaque nature of the CDS market may have contributed to the credit freeze by making lenders less willing to advance funds to borrowers who might be exposed to bad debt, such as Lehman Brothers debt.
- The need for CDS-protection sellers to find collateral to meet unanticipated claims may have contributed to declines in equity (stock) markets.

In summary, critics of CDSs claim that rather than limiting risk as intended, the CDS market actually spread risk. While these claims are hotly disputed,¹¹ it is important that these criticisms do not refute the beneficial uses of CDSs. Rather, they point to imperfections in the market affecting price discovery, assurance of payment, and collateralization. Thus, improving rather than restricting the CDS market is the appropriate remedy for these problems.

The Options for Trading Financial Instruments

CDSs are bilateral contracts negotiated directly between parties. Certain brokers and services help to match interested buyers and sellers, but final negotiations are typically through one-to-one telephone or e-mail communications. Until now, financial settlements were also made directly between the parties, and the result has sometimes been disputes, delays, and uncertainty. Proposals to reform the CDS market include requirements for central clearing or exchange trading.

With central clearing, arrangements for trades are still made bilaterally (over the counter), but a financial intermediary handles financial exchanges to complete the contract. This service is similar to a real estate escrow arrangement, except that it continues through the life of a CDS contract (typically five years). Central clearing reduces mistakes, disputes, and uncertainty in financial transactions.

9. Money Market Working Group, *Report of the Money Market Working Group*, Investment Company Institute, March 17, 2009, p. 3, at http://www.ici.org/pdf/ppr_09_mmwg.pdf (April 13, 2009).

10. Christopher Whelan, comments at American Enterprise Institute conference on “What Is to Be Done with Credit Default Swaps?” February 23, 2009, at http://www.rcwhalen.com/pdf/cds_aei.pdf (April 13, 2009).

11. See Peter J. Wallison, “Everything You Wanted to Know About Credit Default Swaps—But Were Never Told,” American Enterprise Institute *Financial Services Outlook*, December 2008, at http://www.aei.org/publications/pubID.29158/pub_detail.asp (April 13, 2009).

Exchange trading involves bids and offers to anonymous parties in a widely traded market. Trades are made between a buyer or seller and a market specialist rather than directly between buyer and seller. Exchange trading requires a large market with frequent trades. For instance, most U.S. stocks are now traded on exchanges, but bonds and other less widely traded instruments lack sufficient volume to make exchange trading practical.

The CDS Market's Imperfections

Critics have decried the unregulated nature of the CDS market. Yet in considering what, if any, new regulation is needed, it is important to understand that the CDS market has evolved like all other markets. Creating a CDS market as a full-blown exchange would have been impossible, just as the traders who met outdoors on Wall Street in the 19th century or made small stock trades individually over the telephone in the 1970s could not have created the New York Stock Exchange or NASDAQ Stock Market in their times. In fact, the inflexibility of the U.S. financial regulatory structure is one important reason why the CDS market evolved imperfectly.

While CDSs are similar to several other financial products, they do not fit neatly into the regulatory structure, which was developed largely in the 1930s. CDSs are similar to insurance, but certain CDS features, such as payments to a party who has not suffered an actual loss, would be illegal if offered as insurance. CDSs are also similar to futures, but commodity laws require futures to be traded exclusively on exchanges. Exchange trading requires standard contracts, but some CDSs are highly customized, making it impossible to trade all CDSs on exchanges, although they are more standardized today than when they were developed in the 1990s.

Because of these inflexible regulatory requirements, CDS products were structured and markets developed to avoid existing regulatory categories. Overly strict regulation backfired by forcing CDS market participants wholly outside of the regulatory

system. Rather than attempting to force CDSs and other innovative products into the 1930s-style regulatory straightjacket, policymakers should adapt regulatory schemes to market developments.

The Changing CDS Market

The CDS market is changing in two fundamental ways: Clearinghouses will begin clearing many CDS trades, and CDS dealers have agreed on a series of changes in how CDS are priced, traded, and resolved after credit events that trigger payments.

Central Clearing. Under the aegis of the Federal Reserve Bank of New York, CDS market participants have been meeting since 2005 to discuss improvements in the CDS market structures.¹² Without regulatory mandates, derivatives market participants have moved to improve the efficiency and transparency of their markets by such steps as electronic trading and recordkeeping, trade netting, and centralized data collection and publication. The Depository Trust and Clearing Corporation, an industry service organization, has begun to release weekly reports on CDS trade volumes and value.¹³ These intermediate steps pointed ultimately toward a clearinghouse for CDS trades.

Regulators and market participants agree that a central counterparty or clearinghouse for CDS transactions will address existing market imperfections. A clearinghouse will act as intermediary for all CDS transactions, largely eliminating counterparty risk of a trading partner or broker being unable to keep its side of a bargain. A clearinghouse will reduce gross risk exposure by "netting" offsetting contracts and will make trade settlement virtually immediate. A clearinghouse can publish prices and trade volume, making the market more transparent, and will provide regulators with information about participants' positions and risk exposures. Finally, a clearinghouse will increase liquidity by imposing capital and margin requirements on clearinghouse members and by maintaining its own capital cushion.

12. Federal Reserve Bank of New York, "OTC Derivatives Market Infrastructure," Web page, at http://www.newyorkfed.org/newsevents/otc_derivative.html (April 13, 2009).

13. Depository Trust and Clearing Corporation, "DTCC Deriv/SERV Trade Information Warehouse Reports."

In short, a clearinghouse will make the CDS market more transparent, more liquid, and less risky.

One of the major barriers to establishing a CDS clearinghouse was the balkanized U.S. regulatory framework. While the Commodity Futures Modernization Act allows any one of three agencies to approve a derivatives clearinghouse, the SEC's insistence that it should retain authority over clearinghouses approved by other agencies and disparate regulatory standards and aims slowed and frustrated efforts to establish one or more clearinghouses.

Following the market crisis, the regulatory agencies worked together. In November 2008, they announced a memorandum of understanding in which the Federal Reserve, Commodity Futures Trading Commission (CFTC), and SEC agreed to cooperate, share information, and harmonize regulatory requirements for a clearinghouse for credit derivatives. Final regulatory approvals took several additional months, but one European and two American clearinghouses have been approved to clear CDS trades. On March 9, ICE Trust, operating under regulation of the New York Federal Reserve Bank, began clearing some CDS trades. ICE is beginning with widely traded and highly standard CDS indexes and will later expand to other types of CDSs.

The fact that market participants have been cooperating to improve operations for several years while regulators are only now collaborating to improve the regulatory process is an important reminder that the private sector is often more willing and able to reform in the face of financial challenges than regulators are.

Regrettably, Congress is even further behind the curve than regulatory agencies are. The House Agriculture Committee recently approved legislation that would mandate CFTC regulation and strip the Federal Reserve of authority to regulate CDS clearing.¹⁴ Yet major CDS dealers are banks, which is a powerful argument that Fed regulation is appropriate.

Even if CFTC regulation were a good idea in the abstract, an abrupt shift in the regulatory frame-

work would pull the plug on a four-year cooperative public and private-sector effort to improve CDS markets. Disrupting a government-encouraged private-sector effort at the very moment that it is beginning to bear fruit would be disastrous both economically and from a public policy perspective. Markets would suffer, and it would not likely improve the regulatory outcome.

The Obama Administration apparently plans to propose requiring central clearing for standardized derivatives contracts. The market has matured to a point where such a requirement for many types of CDSs is at least feasible, even if not necessary.

However, any regulatory structure needs to be flexible enough to allow continuing innovation and experimentation. Prior to recent market revisions, few CDSs would have been easily cleared. New products should be given an opportunity to develop fully before clearing or similar requirements are imposed. Exchange trading, which the Administration plans to "encourage," is not practical in the near term because the CDS market lacks sufficient volume to support anonymous auction trading.

Trading Conventions and the "Big Bang." Beginning on April 8, CDS trades fell under new rules that affect pricing, trading dates, and the determination and settlement of payment obligations. The International Swaps and Derivatives Association, a trade association of credit derivatives market participants, functions in some respects as a private-sector regulator of CDS markets.¹⁵ ISDA definitions and standard agreements provide the basis for individual CDS trades. The ISDA changes are so significant that they are referred to in the industry as the "big bang."

CDS prices will now be calculated through a combination of an initial "up-front" payment and a standard "coupon" (the periodic premium) of either 1 percent or 5 percent per year depending on creditworthiness. This will make CDS pricing more consistent and transparent, facilitating better price discovery and readier comparisons to related finan-

14. Derivatives Market Transparency and Accountability Act of 2009, H.R. 977, 111th Cong., 1st Sess.

15. Private-sector regulation of financial markets is common. Stock exchanges regulate their members. The Financial Industry Regulatory Authority regulates securities firms. Even the U.S. Federal Reserve System is partially private.

cial products. Trades will have standard quarterly expiration dates.

Until now, parties to swaps sometimes disagreed about whether or not a credit event triggering a payment obligation had occurred.¹⁶ Disputes about credit events must now be submitted within limited time periods to “determinations committees” assembled by the ISDA. Creation of a regular and objective mechanism for settling disputes should reduce the uncertainties and, therefore, the costs associated with CDS trades.

Finally, the new trading conventions specify that the normal method for settling CDS obligations after a bankruptcy or missed payment will be to auction the bonds or other debt at issue. Previously, auctions have frequently been used for this purpose on a voluntary basis. Making auctions standard should make settlement more predictable and pricing more equitable.

These new trading conventions have been developed by market participants after years of trial and experience. They will make CDS contracts easier to clear and the market more transparent and efficient. Continuing standardization could even lead to exchange trading for some categories of CDSs.

However, regulators were unlikely to develop these conventions, which required years of market development and experimentation by the market participants. As policymakers consider whether further regulation of CDS markets is needed, they should keep in mind that market mechanisms and responses are often the best solutions, even to ostensibly regulatory problems.

What Policymakers Should Do

Policymakers have focused excessively on alleged market excesses as the cause of the financial crisis and on increased regulation as the appropriate solution. While market excesses clearly played a role, developments in credit derivatives markets are a reminder that overly complex, inflexible, and outdated government regulations contributed to market dysfunction.

The most productive regulatory reforms may not be new or increased regulation, but rationalization of regulatory schemes to address modern market needs and practices. Specifically:

1. Policymakers should encourage market reforms to market problems.

The private sector has taken substantial steps to address weaknesses in credit derivatives markets. Regulators are taking productive steps to encourage and facilitate that reform. Further regulatory reforms should focus on improving market structures and incentives rather than on increasing government intervention and control of markets.

Rather than simply assuming that more regulation is needed or seeking a comprehensive regulatory system for ideological or theoretical reasons, advocates of additional regulation should be required to identify specific market deficiencies and craft targeted responses rather than blanket mandates.

Using the New York Fed’s credit derivatives effort as an example, regulators should consider cooperative discussions with market participants prior to coercive market intervention. In the case of credit derivatives, regulators and market participants largely agreed about the existence and nature of market defects. Market participants were able to develop innovative solutions and implement them more quickly than regulators were.

2. Policymakers should consider how existing regulation contributed to market deficiencies.

Recent improvements in the derivatives market are a reminder that regulatory balkanization and overlap contributed to market imperfections. For instance, many reform proposals would create new regulatory agencies to address the safety of particular financial products or to promote overall market stability. Before Congress creates a “super financial regulator” or a safety board, it should review the jurisdictions and purposes of existing regulatory agencies to ensure that the government is contributing to, not hindering, productive reforms of the financial system.

16. U.S. Securities and Exchange Commission, Office of Inspector General, *SEC’s Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program*, September 25, 2008, p. 27, at <http://www.sec-oig.gov/Reports/AuditsInspections/2008/446-a.pdf> (April 13, 2009).

Congress has already ordered a review of regulation of over-the-counter credit derivatives in the Emergency Economic Stabilization Act. This review and any subsequent congressional action should focus as much on rationalizing existing regulatory jurisdiction as on imposing new requirements on credit derivatives markets. Simply creating new regulatory agencies on top of existing bodies would make matters worse.

3. Rules should be flexible to allow for and react to changes in markets.

Policymakers should keep in mind that markets evolve. Markets cannot be created by government fiat, and they are distorted by government intervention. Where regulation is necessary, it should be flexible enough to allow continued market evolution and to respond to that evolution in appropriate ways. Sound regulation interacts with markets rather than insisting that markets conform to pre-conceived government categories and jurisdictions.

While central clearing for many CDS contracts is now feasible, regulations should remain sufficiently flexible to allow new or revised credit products to trade and develop in non-cleared markets. Over time, successful products will develop sufficient volume and standardization to permit clearing or exchange trading. However, imposing such requirements on new products when they are initi-

ated would prevent useful experimentation and market evolution.

Those who would disrupt derivatives market improvements by mandating a change in regulatory jurisdiction should be required to meet the high burden of proof that the regulatory disruption is both necessary and likely to improve current arrangements. The House Agriculture Committee's proposal to restrict derivative clearing to CFTC-regulated clearinghouses fails both prongs of this test.

Conclusion

CDSs and derivatives more generally play an important and productive role in the economy. While the CDS market was imperfect, arguments for draconian regulation are poorly supported and inconsistent.

CDS market participants have recently taken significant steps to improve the market. Government should encourage continued market improvements rather than reflexively impose new regulation. If regulatory changes are made, policymakers should seek to improve the regulatory structure rather than simply creating new agencies or rules on top of an already complex regulatory scheme.

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