

WebMemo



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Senator Dodd and Derivatives: How the Market Has Made Regulation Redundant

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Eighteen months after the financial crisis, Senator Chris Dodd (D-CT) and the Obama Administration are suddenly in a hurry to pass financial reform legislation, including blanket regulation of over-the-counter (OTC) derivatives.¹ Dodd's derivatives proposal, as adopted by the Senate Finance Committee last week,² ignores changes in derivatives markets following the financial crisis, thus amounting to legislative bank-bashing.

The test of any derivatives market reform proposal is whether it recognizes the substantial changes in the structure and operation of those markets in the prior 18 months. The current Dodd language fails this test on four grounds:

1. It imposes top-down mandates;
2. It requiring one-size rules;
3. It preserves bureaucratic jurisdiction; and
4. It does not account for market changes.

Derivatives and the Financial Crisis. Many derivatives, such as those related to stocks and commodities, are already traded on exchanges and regulated as traditional securities. Prior to the financial crisis, however, significant categories of financial derivatives—principally those related to interest rates, foreign exchange, and debt (credit default swaps [CDS] on bonds)—were traded OTC directly between major banks.

Losses on financial derivatives at Lehman Brothers and AIG were key events in the financial crisis of 2008. Moreover, some observers believe lack of information about derivatives exposures of major

banks contributed to the freeze-up of credit markets in October 2008. This is not to say that derivatives caused the financial crisis; rather, ill-advised uses of derivatives and imperfections in OTC derivatives markets represented weak points at which the crisis was manifested most intensely.

Consensus on Improvements. There is significant consensus among derivatives market participants and regulators about the desirability of improving market infrastructure, enhancing financial stability, standardizing products, and providing transparency for market participants, the public, and regulators. There is further agreement that central clearing and exchange (or otherwise open) trading are important means of achieving some of these goals.

How Markets Have Reformed. Operating under the aegis of the Federal Reserve Bank of New York, OTC derivatives market participants have engineered and implemented major changes in OTC derivatives markets over the past 18 months aimed at improving transparency and market stability.³ These steps have included:

- **Standardization.** Standardizing products reduces the potential for disputes between parties and

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makes it easier to assess the financial status of parties to OTC derivatives trades. Market participants have greatly standardized products through a “big bang” and “small bang” in CDS trading conventions in 2009, increased standardization in interest rate swaps, and devised standard legal definitions and trading conventions across OTC markets.

- **Transparency.** Increasing transparency gives market participants, regulators, and the public better information about prices, market risks, and the stability of parties. In July 2009, market participants established a “trade warehouse” for OTC CDS that provides price and volume data to the public and more detailed information to regulators.⁴ A repository for interest rate derivatives was established recently with public reporting to begin April 30, 2010. Reporting for OTC equity derivatives will begin July 31.
- **Central clearing.** Central clearing improves market stability by guaranteeing trades even if one party becomes insolvent. Since the end of 2008, six clearinghouses—two in the U.S. and four in Europe—have begun clearing CDS trades, with over 95 percent of new eligible trades now cleared. Clearing of interest rate derivatives began last year, with 90 percent of new eligible contracts now centrally cleared. Both the range of products cleared and participants eligible to access the clearinghouses are continually expanding.
- **Market practices and infrastructure.** Market participants have effectively eliminated delays in completing trades. They have standardized and begun daily collateral reconciliations and established new mechanisms to resolve valuation disputes. Dealer banks and vendors have begun

creating the electronic infrastructure that will enable trading on exchanges or alternate electronic platforms.

These and other steps amount to a huge and rapid evolution of a complex market. This magnitude of change was possible with minimal disruption because market participants themselves planned and implemented the changes. Replacing this market-driven process with command-and-control regulation, as Dodd proposes, will slow the pace of productive change and result in less satisfactory outcomes for the very policy goals Dodd and regulators seek.

The Dodd Bill’s Failures:

Top-Down Mandates. The Dodd bill requires every derivative transaction, buyer, seller, or trader to be regulated by bureaucrats. Policy should focus on goals rather than means, leaving markets to devise optimum ways to address legitimate policy concerns.

One Size Fits All. Central clearing has multiple benefits. But not every derivatives trade can or should be centrally cleared. For instance, central clearing may deprive some derivatives users of significant hedge accounting tax benefits. Mandatory clearing may also interfere with certain bank capital rules.

Given reasonable flexibility, users and regulators can address the interplay among securities, tax, and bank regulations and commercial needs. A universal clearing mandate with a complex exemption process is certain to produce unintended consequences.

Bureaucratic Boxes. Because the first derivatives related to commodities and stocks, they were regulated by the Commodities Futures Trading Commission (CFTC) and the Securities and Exchange

1. A derivative is a financial instrument whose price is determined by reference to an underlying asset, such as a stock, bond, currency, or commodity. Derivative prices often move in asymmetric or inverse relationship to the price of the underlying asset.
2. The bill can be found at http://banking.senate.gov/public/_files/ChairmansMark31510AYO10306_xmlFinancialReformLegislationBill.pdf (March 30, 2010). The 1,336-page bill includes 227 pages of derivatives mandates.
3. For a list of New York Fed actions on derivatives, see Federal Reserve Bank of New York, “OTC Derivatives Market Infrastructure,” at http://www.newyorkfed.org/newsevents/otc_derivative.html (March 30, 2010).
4. See Depository Trust and Clearing Corporation, “DTCC Deriv/SERV Trade Information Warehouse Reports,” at <http://www.dtcc.com/products/derivserv/data/index.php> (March 30, 2010).

Commission (SEC). OTC derivatives are related to financial products traditionally offered by banks. Dodd's bill mandates joint regulation of derivatives by the CFTC and SEC for no better reason than existing bureaucratic jurisdiction.

The New York Fed effort shows that banking regulators can supervise these bank-related markets rather than requiring them to conform to bureaucratic categories. Dodd's draft, on the other hand, simply protects turf in Washington.

Behind the Curve. Dodd's derivatives provisions ignore the substantial changes in markets since 2008. Because markets move more quickly than do regulations, it is impossible for detailed legislation to keep up. Micro-managerial mandates will slow the pace of reform and likely misdirect it.

For instance, market participants have requested specific legislation to ensure the legal safety of derivatives trades in clearinghouses.⁵ The Dodd bill imposes a complex clearing mandate but ignores the request for simple legal changes required to ensure the safety of those trades.

Deriving Better Solutions. Dodd indicates that his derivatives proposal is likely to be replaced, possibly by a bipartisan compromise from Senators Jack Reed (D-RI) and Judd Gregg (R-NH). A serious effort to improve derivatives markets would:

- *Recognize the significant changes in derivatives markets since 2008.* Legislative mandates addressing problems that no longer exist is simply bank-bashing.

- *Focus on systemic issues rather than blanket regulation.* Clearing over 95 percent of new CDS trades by definition addresses systemic risks. Imposing a bureaucratic exemption process, on the other hand, would create huge costs with no systemic benefits.
- *Seek policy goals through market-driven change.* The New York Fed effort demonstrates the power of a market-based process for achieving policy goals. Congress should set goals rather than mandating detailed means for achieving them.
- *Shape regulation to markets rather than markets to regulation.* Requiring products and markets to conform to existing bureaucratic categories would stifle innovation with little policy benefit. Rather than obsessing about who is regulating, Congress should address real problems blocking progress toward increased central clearing, exchange trading, and similar policy goals.

Rapid reforms in derivatives markets since 2008 have made command-and-control regulation represented by the Dodd draft redundant. Lawmakers should understand that imprudent regulations, such as top-down mandates and inflexible rules that inhibit the private market, are worse than no regulations at all.

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5. See Stuart J. Caswell, Managed Funds Association, letter to Deputy Treasury Secretary Neal S. Wolin, February 12, 2010, at http://www.managedfunds.org/downloads/Bankruptcy_Letter_to_Deputy_Secretary_Wolin_final.pdf (March 30, 2010).