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The "Comprehensive" Problem with Derivatives Regulation

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Persuaded that lax regulation of financial derivatives contributed to the 2008 financial crisis, policymakers in Congress and the Obama Administration have adopted a knee-jerk solution: regulate everything.

The Obama Administration has proposed and the House Financial Services and Senate Banking Committees have each approved schemes for regulating derivatives that differ in many details. But the proposals agree on the most significant point: that derivatives regulation must be "comprehensive." By "comprehensive," regulators mean that every financial product, every buyer, every seller, every intermediary, and every transaction must be regulated unless expressly exempted by statute or decree.

The premise supporting the blanket regulatory diktat—that every derivative contract poses systemic risk to the financial system—is unproven, the application overly broad, and the resulting bureaucratic burden excessively heavy. Congress should:

- Resist simplistic calls for "more regulation" until proponents demonstrate that particular types of derivatives caused or intensified the financial crisis;
- Apply any new regulation to the derivative products, institutions, or market mechanisms that caused economic harm; and
- Tailor regulation to address specific problems or harms identified.

Did Derivatives Cause the Financial Crisis? The differing financial reform proposals passed by the House and awaiting consideration in the Senate would impose comprehensive derivatives regulation by subjecting derivatives now traded over-the-counter (OTC) by banks and other financial institutions to regulation by the Commodity Futures Trading Commission (CFTC) and/or the Securities and Exchange Commission (SEC).

Proponents of additional derivatives regulation apparently view the need for more regulation as self-evident. CFTC Chairman Gary Gensler analogizes derivatives regulation to building codes to prevent fire[1]—without, however, explaining what role derivatives played in the financial conflagration.

In the wake of the 1987 stock market crash, then-New York Stock Exchange Chairman Richard Phelan blamed a new and fast-growing derivative—S&P 500 Index futures—traded on the Chicago Mercantile Exchange. Phelan's charge sparked an outcry for more regulation. But after the crisis subsided, careful studies concluded that the 1987 crash was caused not by derivatives but by macroeconomic factors and government policy mistakes such as anti-takeover legislation. To the extent that flaws in markets intensified the crash, the problems were in the NYSE's own antiquated order fulfillment system.[2]

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In the wake of Lehman Brothers' 2008 bankruptcy, former Lehman CEO Dick Fuld blamed a new and fast-growing derivative—credit default swaps (CDS)—for his firm's failure, fueling calls to regulate CDS. But after a year's review, Lehman's bankruptcy examiner found that Lehman failed due to its own poor business decisions. There was also evidence that Fuld himself approved misleading financial statements.[3] Lehman's derivatives positions represented only about 3.3 percent of its net assets, and the examiner found its derivatives trades were reasonable and more carefully monitored than other asset classes.[4]

There is legitimate debate about the role that credit default swaps (CDS), and other derivatives played in the 2008 financial crisis.[5] But as Phelan and Fuld's inaccurate accusations show, initial claims can be misleading. Awaiting the conclusions of the Financial Crisis Inquiry Commission and other careful studies would empower Congress to make informed decisions rather than simply throwing a regulatory blanket over anything called a derivative. Congress and the CFTC cannot design a useful "building code" until they understand the role, if any, that derivatives played in the crisis.

Are All Derivatives the Same? Derivatives are financial instruments used to transfer risk from a party seeking to "hedge" (limit) risk to a party willing—for a fee—to assume the risk. Risks transferred may be related to prices (whether they rise, fall, or fluctuate), interest rates, exchange rates, or they may be related to whether a third party will pay its debts.

Derivatives play a productive economic role by allowing firms to plan based on stable economic factors while transferring the risk (including the potential reward) of economic disruptions to others who are willing and able to assume it. The term *derivative* applies to this diverse set of products because their value is determined by reference to another underlying product or transaction.

Some derivatives, such as commodity or stock futures, are regulated by the CFTC or SEC. Other derivatives related to interest rates, foreign exchange, and debt (called "financial derivatives") are traded largely OTC among banks, whose operations are regulated by the Federal Reserve and other banking agencies.

Financial derivatives differ significantly from commodity derivatives in their characteristics, uses, and markets. For instance, most non-financial derivatives involve a single payment followed by settlement at the end of the contract term, such as a commodity future that sets in advance the price to be paid when products are delivered months later. In contrast, many financial derivatives involve long-term streams of payments between parties, which is more akin to a typical lending relationship.

There is no suggestion that interest rate swaps (the largest category of OTC financial derivatives) or foreign exchange swaps played any role in the financial disruptions of 2008. Yet the House and Senate

1. Commodity Futures Trading Commission, "Remarks of Chairman Gary Gensler, OTC Derivatives Reform, FIA's Annual International Futures Industry Conference, Boca Raton, Florida," March 11, 2010, at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-33.pdf* (April 14, 2010).
2. Peter Fortune, "Stock Market Crashes: What Have We Learned from October 1987?," *New England Economic Review*, March/April 1993, at *http://www.bos.frb.org/economic/neer/neer1993/neer293a.pdf* (April 14, 2010).
3. See Examiners Report, Lehman Brothers Holdings, Inc., Chapter 11 Proceedings at 16–17, 996–1002, at *http://lehmanreport.jenner.com* (April 15, 2010).
4. *Ibid.*, at 568–578.
5. *See*, e.g., David M. Mason, "Credit Derivatives: Market Solutions to the Market Crisis," Heritage Foundation *Backgrounder* No.2262, April 23, 2009,at *http://www.heritage.org/Research/Reports/2009/04/Credit-Derivatives-Market-Solutions-to-the-Market-Crisis*; David M. Mason, "Senator Dodd and Derivatives: How the Market Has Made Regulation Redundant," Heritage Foundation *WebMemo* No. 2850, March 31, 2010, at *http://www.heritage.org/Research/Reports/2010/03/Senator-Dodd-and-Derivatives-How-the-Market-Has-Made-Regulation-Redundant*; Peter J. Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," AEI Outlook Series, December 2008, at *http://www.aei.org/outlook/29158* (April 15, 2010).

proposals extend regulatory rules for physical commodities and stocks to these bank-based products. Wantonly extending commodity-focused regulation to financial derivatives applies the wrong tool in the wrong application. The result would be ineffective regulation damaging everything involved. For instance, commodity and stock futures are normally settled by physical delivery whereas most financial derivatives are settled by cash payments—often over an extended period.

Is "Comprehensive" Regulation Appropriate or Necessary? Gensler is anxious to impose a clearing mandate, among other rules, on OTC derivatives. The mandate would require most derivative contracts to be settled through a clearinghouse rather than directly between the parties. The clearinghouse acts as a middleman, receiving and distributing payments after a contract is formed between the original parties. This arrangement arguably reduces the risk that a contract will not be honored.

What percentage of OTC derivatives contracts can be cleared, at what cost, is critical to determining whether a clearing mandate is appropriate. Gensler asserts that 75 percent of OTC derivatives could be centrally cleared. Gensler's source, however, is not an analysis by his agency, a peer-reviewed study, or a market survey. The only evidence Gensler cites is a ballpark estimate by a single executive whom Gensler never names.[6]

An agency head owes Congress and the public more than an uncorroborated opinion from an unnamed source to justify a massive expansion of regulatory authority. Gensler has not bothered to address this question rigorously, but he has made up his mind and is eager to issue orders to the market.

Gensler and other Obama Administration officials also insist that exemptions to derivatives rules be very narrow. For instance, the Senate Banking Committee bill requires approval from both the principal regulatory agency and certification by the Financial Stability Oversight Council to exempt any end user, swap dealer, bank, non-bank financial institution, security, or other product from derivatives rules. Imposing a duplicative exemption process guarantees that one-size-fits-all mandates will be imposed with little reason.

Uniformity: At What Cost? For What Purpose? The principal justification for regulating derivatives is that they pose "systemic risks" to the financial system. Yet some derivatives, such as interest rate swaps, pose no systemic risk because their values change slowly and their characteristics are well understood. Other derivative types or user categories are so small as to be insignificant to the overall financial system. Gensler acknowledges, for instance, that corporate end users represent only about 9 percent of derivatives transactions, but he argues against their exemption from collateral requirements for no better reason than to uphold the "regulate everything" principle.[7]

Applying ill-designed blanket regulation will make financial derivatives more costly, more difficult to customize, and consequently less widely used. Because properly used derivatives reduce rather than increase financial risks, bad regulation will increase rather than reduce overall risk in the economy.

"Do Something, Anything." The Obama Administration and committees in Congress propose to regulate financial derivatives with an antiquated scheme designed for physical commodities. This inflexible and damaging mandate is unjustified. Instead, Congress should:

- Consider carefully any evidence that particular types of derivatives caused or intensified the financial crisis;
- Craft regulations to address specific problems rather than imposing blanket mandates; and
- Create rules that encourage rather than discourage risk-mitigating uses of financial derivatives.

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6. See Gensler's remarks on January 6, January 29, February 24, March 1, March 2, March 9, and March 11, 2010, at *http://www.cftc.gov/PressRoom/SpeechesTestimony/index.htm* (April 14, 2010).
7. Commodity Futures Trading Commission, "Remarks of Chairman Gary Gensler, OTC Derivatives Reform, Chatham House, London," March 18, 2010, at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-35.pdf* (April 14, 2010).

Leading derivatives reform proposals amount to little more than a frenzied insistence to do something, anything, to regulate financial derivatives. Proponents must show why particular derivatives need to be more closely regulated and that the schemes they propose will reduce rather than increase risks in financial markets.

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