How Should We Regulate Derivatives Markets?

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Introduction

This briefing paper provides background on the derivatives markets and their role in the financial crisis, and evaluates aspects of the main reform proposals before Congress. On July 30, 2009, the chairs of the House Financial Services Committee and the House Agriculture Committee outlined their joint principles for new derivatives legislation (the Frank-Peterson principles). On August 11, 2009, the Obama administration released its proposed "Over-the-Counter Derivatives Markets Act of 2009" (the Treasury plan). On June 26, 2009, the House passed the American Clean Energy and Security Act (Waxman-Markey), which would impact a wide range of derivatives.

The architecture of derivatives markets is now in play because of two, related policy concerns that arose from the financial crisis: systemic risk and market efficiency. Systemic risk is the danger that failing financial institutions will destabilize the financial system and thereby threaten the wider economy. When unconstrained by effective risk management or regulation, derivatives enable high concentrations of risk in individual financial institutions. Derivatives markets are efficient if trading costs are low and risk is well distributed among investors. The most important ingredient for market efficiency is competition, which in turn depends on price transparency and on relatively unencumbered access to trading by a broad set of market participants.

After a brief review of the institutional features of derivatives markets, Duffie outlines what went wrong with them during the financial crisis, and evaluates the main proposals with respect to several stated policy options that are believed, in varying degrees, to reduce systematic risk or improve the efficiency of the derivatives markets. They are: centralized clearing, improved price transparency, improved position transparency, migration of over-the-counter trading to exchanges, speculative position limits, and improved corporate governance in the area of risk management.