Derivatives

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Derivatives are financial instruments that were created to reduce risk, and their use on Wall Street is known as hedging. In recent years, however, as their prevalence and complexity ballooned, they created new kinds of risk and played a major role in the meltdown of the world's financial system. The financial regulatory overhaul passed in July 2010 will turn trading in derivatives from a highly profitable niche to a more regulated, public business focused on volume.

The name "derivative" comes from the fact that their value "derives" from underlying assets like stocks, bonds and commodities.

In the years leading up to the financial crash, banks made billions by selling complex derivative contracts directly to buyers, pocketing hefty fees but absorbing considerable risk as well. Now, most derivatives will be traded through clearinghouses, which will bear the risk, leaving banks to simply broker the transaction. The shift to clearinghouses will turn derivatives trading from a high risk, high reward enterprise to a more volume-based business, in which banks will have to compete on customer service and price.

Much of the most bitter fighting over the financial regulatory bill concerned a Senate provision that would have made banks spin off their lucrative derivative businesses. The provision stayed in the final bill, but was loosened significantly.

After passage, the financial industry lobbied vigorously to shape new structures like the clearinghouses, and the thousands of regulations being written, to their liking. They were supported by a number of Republican lawmakers. As a result, by the end of June 2011, the industry had gotten farther at reconfiguring itself than the regulators had at getting the new rules written.

In one victory for the industry, in April 2011, the Commodity Futures Trading Commission made clear that the new rules being developed would cover many known swaps, but exempt insurance products and consumer transactions, like contracts to buy home heating oil.

In September, a federal report showed that the nation's biggest banks had increased their holdings of derivatives to nearly $250 trillion, even as they continued to battle regulators over new rules. The nation's four biggest banks — JPMorgan Chase, Citigroup, Bank of America and Goldman Sachs — held roughly 95 percent of the industry's total exposure to derivatives.

In April 2012, a major provision of the financial regulatory overhaul was tempered in the face of industry pressure. The Securities and Exchange Commission and the Commodity Futures Trading Commission approved a rule exempting broad swaths of energy companies, hedge funds and banks from oversight. Firms will not face scrutiny if they annually arrange less than $8 billion worth of swaps.

The threshold is a not-insignificant sum. By one limited set of regulatory data, 85 percent of companies would not be subject to oversight. After five years, the threshold would reset to $3 billion; it is the same amount suggested by a group of energy companies in a February 2011 letter, according to regulatory records.

When regulators first proposed the rules in late 2010, they set the exemption at $100 million. At that level, only 30 percent of the players would have been excused from the oversight, which was mandated by the Dodd-Frank financial overhaul law.

Background

One of the easiest ways to understand derivatives is to consider an early example — farmers and traders in Chicago in the 19th century buying corn futures. A contract that guaranteed a certain amount of corn at a certain price at a date in the future helped reduce the risk posed by events like drought or floods that could cause sharp swings in prices. But that future also had a value in and of itself, one that rose and fell with the price of corn — when corn prices went up, a contract for corn at a cheap price was worth more. So futures came to be traded as avidly as the commodities they covered.

The most common types of derivatives are futures; forwards, which are futures traded outside of a regular exchange; options, which are the right to buy or sell something at a specified date and price; and swaps, contracts involving an exchange of assets or payments.

In recent years, a bewildering variety of derivatives have been developed. One kind that played a central role in the financial crisis are credit default swaps, which are in essence a form of insurance policy, and whose value swings with the fiscal health of the transaction or asset it is written to cover. Swaps and other derivatives were often sold and resold in ways that attenuated the link between a party who created the thing of value being covered, and helped disguise the level of debt financial institutions were taking on. In the later stages of the housing boom, credit default swaps written in reference to mortgage-backed bonds were themselves bundled into financial instruments, known as synthetic CDOs, or collateralized debt obligations. Investors buying CDOs were essentially placing a wager on whether bonds held by someone else would turn a profit or fail.

At the end of 2008, the Bank for International Settlements in Switzerland estimated the face value of all derivative contracts across the world to be $680 trillion, up from $106 trillion in 2002 and a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them.

Derivatives are hard to value. They are virtually hidden from investors, analysts and regulators, even though they are one of Wall Street's biggest profit engines. They do not trade openly on public exchanges, and financial services firms disclose few details about them.

Throughout the 1990s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. But the financial industry lobbied heavily against such measures, and won backing from important figures, including Alan Greenspan, chairman of the Federal Reserve from 1987 to early 2006.

After the financial meltdown in late 2008, public sentiment swung strongly in favor of tougher financial regulation. In December 2009, House Democrats passed a bill which included a requirement that most derivatives be traded through clearinghouses, which would make the process more transparent and guarantee that both parties to the deal would be able to pay off. The bill contained an exemption for so-called "end users,'' companies that actually intend to use the commodities on which they are buying derivatives, like oil, minerals and agricultural products.

In the Senate, Mrs. Lincoln of Arkansas, introduced a bill in April 2010 that would take a similar approach to clearinghouses and end-user exemptions.The bill would also require most derivatives to be traded on an open exchange.

Currently, the only way to trade many derivatives is to call up various dealers and ask for the price at which they are willing to buy or sell. The securities dealer profits from the difference between the prices at which it buys from one party and sells to another. Investors rarely, if ever, see details on the other side of the trade. Wall Street has signaled that it can live with a clearinghouse approach, but it is strongly opposed to exchange trading of derivatives, which would introduce price competition and lower the profits.

Wall Street bankers were stunned by the most aggressive portion of Ms. Lincoln's bill, one that is opposed even by the Obama administration. That proposal would essentially ban banks from being dealers in swaps or other derivatives by taking away their access to federal deposit insurance and their ability to borrow from the Federal Reserve if they kept those businesses.

The provision was approved as part of the Senate bill and made its way into the compromise worked out by the House and Senate. But Democrats from New York, where most of the big banks who would have been hurt by it, pushed back and won significant changes that made it easier for financial firms to live with the idea. As passed, the measure requires that banks, which are major participants in the swaps market, segregate those operations from their commercial banking business.

The final version of the financial overhaul bill imposes multiple new regulations on the derivatives market generally and the swaps market in particular. It requires that standardized derivatives contracts be traded on an open exchange, with prices and volumes reported publicly. The contracts must also be cleared through a third party, an intermediary who guarantees that if one party defaults, the investor holding the other side of the trade will still be paid. Clearinghouses will perform that function by requiring parties in a derivative trade to put up collateral, or margin, to protect against a default. The bill also requires securities firms that trade derivatives to maintain certain levels of capital. Overseeing all this activity is the Commodity Futures Trading Commission, in the case of derivatives involving commodities like soybeans, oil or metals, and the S.E.C. for security-based transactions.