

Requiem for a Market: An Analysis of the Rise and Fall of a Financial Futures Contract

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Abstract

Futures contracts often include a variety of delivery options that allow participants flexibility in satisfying the contract. These options have the potential to broaden the appeal of the contract. However, if these options are valuable, they may reduce the hedging effectiveness of the contract. This article analyzes the GNMA CDR futures contract that appears to have failed because of flaws in the contract's design. For the first 6 years following its introduction, the contract attracted significant and increasing volume, but, subsequently, the volume declined to almost zero. Over the years during which the volume experienced its most dramatic decline, the Treasury-bond futures contract provided a better hedge for current coupon GNMA securities than did the GNMA CDR futures contract. And, over this same period, the value of the quality option embedded in the contract often exceeded 5 percent of the futures price and reached a level of 19 percent at one point. We interpret the evidence to indicate that the contract failed because the delivery options reduced the hedging effectiveness of the contract for current coupon mortgage securities.

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