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Dodd-Frank Derivatives Regulations Will Bring Benefits, Not Costs To Main Street

New Dodd-Frank derivatives requirements require that companies making bets in the derivatives markets temporarily set aside margin (or collateral) to guarantee their derivatives. This margin protects derivatives users from potential losses if their counterparties end up owing it money on a derivatives trade – it serves as collateral for the implicit loan made to cover the risk that the customer might lose money on their derivatives contract. Posting margin ensures we don't repeat the panic and confusion that un-margined and unregulated derivatives created in financial markets during the crisis of 2008.

An analysis by the Office of the Comptroller of the Currency (OCC) found that safely backing up the $179 trillion of derivatives contracts entered into annually by U.S. banks could require that banks post up to $2.56 trillion in margin.[1] That's a big number. Opponents of reform use that number to exaggerate the impact of derivatives reforms. But the truth is that the only real cost issue associated with derivatives margin postings is the timing of small credit costs. What's more, these timing issues overwhelmingly affect financial institutions, not Main Street end users. But lobbyists for the financial sector are deliberately confusing the issue. Here's how:

- **Confusing temporarily reserving margin with actually spending money:** Margin postings don't require companies to spend money at all. They just require a company to temporarily reserve cash (or non-cash collateral) against possible derivatives losses. The margin is returned to the company when the derivatives risk terminates (less anything actually lost on the derivative, which would have to be paid regardless). While the margin is reserved, it earns interest in a temporary custodial account.

- **Exaggerating the user credit cost of reserving margin:** Since the margin posting is in effect a temporary short term loan, the cost of this loan would be the net interest for holding the money – the interest for using the money minus the interest earned in the temporary custodial account. The OCC report estimates that this cost would be 1 percent of the amount of margin that's reserved. So citing the total amount of margin that might hypothetically be required overestimates costs by a factor of 100!

- **Claiming that any costs of reserving margin fall on "end user" Main Street companies, and not on Wall Street:** According to BIS data, over 90 percent of derivatives contracts are transactions between financial entities – either dealer to dealer,

[1] This is a maximum figure – for various reasons the April OCC report found that the margin figure would likely be significantly lower. The OCC analysis has not been posted on the web but is available on request from AFR.

or between dealers and other financial entities like hedge funds or non-dealer banks. What's more, Dodd-Frank regulations specifically exempt non-financial "end user" companies from posting margin in almost all cases.[2] So the vast majority of margin will be posted by financial entities interacting with other financial entities.

- **Ignoring the fact that user credit costs will be incurred anyway:** But the real issue isn't even the user credit cost, it's only the timing of that cost. Derivatives dealers are big banks that don't give credit away for free. Any bank that didn't charge for letting their customers owe them money would quickly go out of business. So banks already charge customers for their derivatives risk – they just don't ask for the money to cover that charge up front. Instead, they increase the "spread" costs that the customer must pay throughout the life of the derivatives deal. In fact, those spread costs will be reduced by posting margin. That's because reserving collateral up front reduces the risk of a derivatives transaction, and banks charge less for transactions that are lower in risk. (Just like you pay a lower interest rate on your house when you make a down payment).

It's true that some companies would prefer not to post collateral up front, and pay for any losses later. When a company does that, it can roll the dice that it will end up "in the money" throughout the entire life of the derivative and will never have to actually pay cash to its dealer at all. But that's not good risk management. A temporary margin posting helps ensure that the company will take seriously the risks and costs associated with using derivatives, and plan for these risks. And it will lower the total cost of the derivative over the entire life of the contract by preventing additional dealer charges for the credit risk in unmargined derivatives.

That's why posting margin is such a good risk management tool. It's not the creation of government regulators – margin has been the preferred risk management tool in private commodities markets for over 150 years. Private commodities clearinghouses choose to impose margin because it makes sense and controls risk. Requiring this common sense risk management tool is a wise way to avert another financial crisis. The 2008 financial crisis cost our economy millions of jobs and trillions of dollars – and those are real costs to Main Street.

Even beyond the benefits of greater financial stability and improved risk management, new derivatives regulations will produce many benefits for end users. Unregulated "shadow markets" in over-the-counter derivatives are dominated by a small number of big-bank dealers. For end users, that means inflated prices due to lack of competition and lack of good price information. Through introducing open exchanges, transparent price information, and business conduct standards to protect against fraud, Dodd-Frank reforms will address these problems too. Contrary to the claims of financial industry lobbyists, bringing transparency and oversight to our derivatives markets will be a clear benefit to Main Street businesses.

[2] The only exceptions are cases in which the dealer's credit exposure to a specific end user is so high that the dealer's own financial stability would be at risk if the derivatives user can't pay them back. In these high-risk cases, derivatives dealers already require customer margin without any regulatory requirements.