

# The Risks of Over-Regulating End-User Derivatives



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The passage of the Dodd-Frank Act was an historic effort in the wake of the 2008 financial crisis to modernize and tighten federal oversight of the nation's financial services sector.

Among these reforms were a variety of much-needed new rules to bring more transparency and accountability to the derivatives industry. The new law, for example, provides regulators with more power to regulate the over-the-counter ("OTC") derivatives market, requires more derivatives to be traded on exchanges rather than in private transactions, and requires data collection to improve market transparency.

As sweeping as it is, this new regulatory framework for the derivatives industry is more a framework than a detailed set of rules, and there are many blanks for regulators to fill. As a consequence, policymakers must still be wary of unintended consequences as they implement the law.

A particular example deserving of this special attention is the pending regulations of so-called "end users" in the OTC derivatives market. No one doubts that the abuse of some forms of exotic derivatives contributed to the systemic risk that led to the 2008 crisis. But derivatives are an important tool used by major American manufacturing and service companies ("end users") to *manage* and *protect* against risks—not create them. These derivatives contribute little—if anything—to systemic risk.

Federal agencies are nonetheless contemplating regulations that could put the conventional derivatives companies use to hedge against risk in the same categorical box as the speculative trades or trades done by systemically risky firms, even though Congress did not intend for this to occur.

As detailed below, end-user derivatives can help companies—both big and small—protect themselves from fluctuations in the major factors that affect their cost of doing business, such as commodity prices, foreign currency

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and interest rates. These instruments are a different animal from the kinds of financial bets used by hedge funds and investment banks (such as the use of “credit default swaps”<sup>1</sup> made infamous by former insurance giant AIG).

Subjecting these derivatives to the same limitations as riskier speculative trades—such as by imposing “margin” requirements and other overly tough regulations—would unnecessarily burden American companies. It would tie up capital that would otherwise be directed to investment and hiring, drive up the cost of producing goods and services, and ultimately cost American jobs. Ironically enough, the result would be to create more potential risk for the economy, not less.

## Derivatives Demystified

Derivatives come in different varieties. Understanding the unique and specific role of end-user derivatives is critical to understanding why subjecting them to the prescriptive regulatory framework intended for systemically significant firms makes little sense.

### What derivatives are

In general, “derivatives” are any financial instrument whose price depends upon (i.e. is “derived from”) the value of something else—such as the price of a company’s stock, a barrel of oil, or a bushel of corn. Despite their exotic reputation, derivatives are, in fact, surprisingly commonplace. For example, “equity indexed” funds based on the value of a stock index such as the Dow, are a type of derivative. So are commodities futures contracts and various agreements to buy or sell stock at a future date.

Many derivatives—such as commodities futures—are traded on exchanges such as the Chicago Mercantile Exchange. However, most derivatives are traded in private transactions between two entities in so-called “over the counter” (“OTC”) trades that are tailored to address the unique risks of a particular company.<sup>2</sup>

### What derivatives do

A principal purpose of derivatives is to help businesses to reduce uncertainty by managing or reducing risks over which they have no direct control. Companies enter into derivatives transactions because they are worried about potential price fluctuations because of changes in commodity supplies, foreign exchange rates, or interest rates.

A manufacturer of heavy machinery, for example, might be very concerned about the future price of steel. Airlines want to ensure a constant supply of jet fuel at stable prices. Food producers worry about the price of wheat, sugar, and other commodities. A real estate developer may worry about the direction of future interest rates when deciding whether to embark on a new project.

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Derivatives help companies mitigate these potential risks by allowing a company to “lock in” the price of a key commodity, the cost of raw materials or even the interest rate on financing for the company’s future purchases or investments. For example, an airline may enter a derivatives contract to lock in the price of jet fuel for future purchase. If there’s a later spike in the market price of jet fuel, the airline can keep its own costs stable and benefit consumers too by protecting them from a simultaneous spike in ticket prices.

Derivatives help protect companies from any number of unpredictable events. A tornado or tsunami; an accident with an oil rig; tumult in the Middle East; or a sudden uptick in interest rates due to fears of a potential government default are all factors that could run up prices for raw materials and drive up costs for these companies (which in turn drives up what consumers ultimately pay).

## Regulation of end-user derivatives

In addition to many other changes, Dodd-Frank imposed an array of tough new rules aimed at reducing “counterparty credit risk” – that is, the risk that one party to a derivatives contract won’t (or can’t) make good on its obligations. In particular, the new rules demand that certain market participants who use OTC derivatives must post money or other capital into an escrow account for the purpose of covering potential losses from derivatives transactions (also known as margin requirements).

While margin requirements make sense in many contexts to reduce the threat of systemic risk, putting margin requirements on companies that use derivatives to manage risks in the ordinary course of business—i.e. end users—is both onerous and unnecessary. Here’s why:

### **1. Congress never intended end-user companies to be subject to margin requirements.**

In drafting the derivatives provisions of Dodd-Frank, policymakers intended just to tightly regulate only those “systemically important” institutions whose failure could endanger the whole economy. They did not intend the same treatment for companies that use derivatives for the purpose of hedging risk and reducing uncertainty in their businesses.

In fact, the bill’s Senate authors, Senators Chris Dodd (D-Conn.) and Blanche Lincoln (D-Ark.), sent a letter to House Financial Services Committee members Congressmen Barney Frank (D-Mass.) and Collin Peterson (D-Minn.),<sup>3</sup> explicitly stating that the legislation’s intent was to exempt these end-user companies entirely from the margin requirements that would otherwise apply to major swap participants or swap dealers. As the legislators put it, regulators “must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk.”<sup>4</sup>

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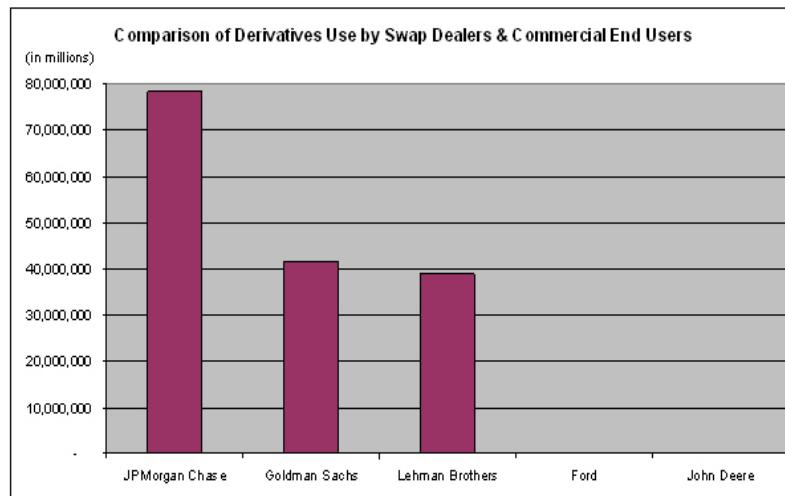
Despite these intentions, the sausage-making process that created the final bill also generated significant ambiguity about who had to meet the new margin requirements. As a consequence, regulators such as the Federal Reserve, the Commodity Futures Trading Commission and the Securities and Exchange Commission now have the discretion to decide how to apply these requirements and to whom. Companies that use OTC derivatives to manage risk and keep costs down for consumers face a real threat of being ensnared in regulations that should not apply to them.

## **2. Companies that use derivatives to manage business risks are not “systemically important.”**

Title VII of the Dodd-Frank Act was meant to mitigate the risks arising from the use of derivatives by systemically important firms—especially banks and insurance companies—that could pull down the whole financial system if they go under. By requiring margin, the party at the other end of a transaction (such as a systemically significant bank) is protected from facing huge losses if the other party can’t make good on its obligations. However, end users—that is, companies that use derivatives to manage business risks—are not systemically risky. Even if they make horrendous business decisions, the repercussions are likely to be limited. No major bank is likely to go under because an auto company failed to post margin on a derivatives trade.

One reason is that the derivatives used by these companies represent a small fraction of the total derivatives market—in fact, derivatives by non-financial users account for less than 10 percent of all derivatives. (Moreover, derivatives as a whole accounted for just 3.4 percent of losses reported by financial institutions since the financial crisis. And most of it was concentrated in AIG—which under Dodd-Frank would be a “major swap participant” that is subject to margin requirements. The vast bulk of losses—about \$2 trillion in total—resulted from other kinds of products such as loans, collateralized debt obligations, etc.<sup>5</sup>)

Secondly, end-user companies don’t run Wall Street. On the contrary, end users are the Main Street businesses and manufacturers that power the nation’s economy. End-user companies include auto manufacturers, airlines, hospitals, real estate owners and developers, and community banks. This is why the authors of Dodd-Frank warned that, “If regulators raise the cost of end-user transactions, they may create more risk for the economy.”<sup>6</sup>



Source: Chatham Financial, based on public financial filings and the Office of the Comptroller of the Currency’s Quarterly Report on Derivatives<sup>7</sup>

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### 3. The price of unnecessary margin requirements will be the loss of American jobs.

Posting margin on a transaction is similar to putting up collateral for a loan, except that it typically requires cash or very liquid forms of collateral and the amounts required can vary wildly based on market fluctuations. A party must set some money aside at the outset of a trade in the event of future losses and can’t use that money for any other purpose. In addition, a party must put up additional collateral when the trade loses value. For systemically important institutions, this makes sense. It helps ensure these firms can weather derivative losses without requiring taxpayer bailouts.

But in the case of end-user companies that use derivatives just to manage risk, margin requirements would unnecessarily tie up billions of dollars that could otherwise go toward growth and investment. Moreover, the amount of money a company might have to post could vary widely because of “mark to market” requirements for calculating margin requirements. This means that the amount of margin required would depend on the current market price of whatever assets are involved in the derivatives contract. (For example, say that an airline enters a futures contract to buy 1 million gallons of jet fuel. The amount of margin required could change from day to day, depending on the price of jet fuel at any given day.)

The result would be that companies would have to keep extra cash on hand to meet sudden increases in margin requirements. This runs counter to end users’ primary objective for hedging in the first place – to reduce uncertainty.

For these companies—which pose no risk to taxpayers—margin requirements would force billions of dollars to sit underutilized. To put this

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possibility into perspective, if the companies in the S&P 500 were subject to a 3 percent initial margin requirement on every derivative trade they entered, it would reduce capital by \$5 billion to \$6 billion per year.<sup>8</sup> As a result, companies would face an unpalatable choice: either post margin and forego those dollars for investment or other purposes; or forego some of their reliance on derivatives to hedge risk, thereby making it more likely that they will behave cautiously and defensively. Neither result is what the economy needs.

These numbers are just the beginning. They don't take into account the total amount of margin that non-S&P 500 companies would have to post if they are subject to these rules. They also don't take into account the possibility that depending on the terms of a specific deal companies might have to put up more money to meet a particular margin requirement. Among other negative impacts, these margin requirements could blunt the effect of such tax measures as the "bonus depreciation" tax credit passed by Congress to stimulate investments and job creation. If capital is tied up in margin, investments for job creation can't happen too.

#### **4. Consumers will pay more.**

Lastly, protecting end-user companies from margin requirements can help protect another set of end users: consumers who need stable prices to plan vacations, buy groceries, or complete the multitude of daily tasks we all face.

End-user companies use derivatives to hold costs down in the face of unpredictable prices. Energy companies use derivatives to maintain stable electricity prices for homeowners. The agriculture industry uses them to ensure the price of grocery staples doesn't fluctuate widely—which benefits families. Forcing end-user companies to meet margin requirements would either raise their costs or cause them to hedge less. In either scenario, the impacts will surely be passed along to consumers.

## **Conclusion**

No doubt, Washington's number one priority is jobs. With an unemployment rate over 9 percent and foreign economic superpowers like China growing at an astonishing pace, we can't afford to ignore either opportunities to create jobs or a chance to prevent the loss of jobs because of overregulation and underinvestment.

As we emerge from the worst recession in generations, policymakers are confronted with the dual task of implementing regulations that promote private sector economic growth while also mitigating systemic risk. Sensible regulations to deal with end-user derivatives and the companies that use them are an important piece of meeting this challenge.

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1 This is not to imply that all credit default swaps are risky—they too have a role, if properly used, in helping companies hedge against risk. The manner in which AIG used these derivatives was what created the risk.

2 Because exchanges are strictly regulated and OTC trades are not, and because OTC-traded derivatives included instruments such as credit default swaps, OTC-traded derivatives became the target of tough scrutiny after the 2008 crisis.

3 Ibid.

4 <http://online.wsj.com/public/resources/documents/dodd-lincoln-letter070110.pdf>. Accessed January 6, 2011.

5 Bloomberg's WDCI function as of 2/25/11.

6 Ibid.

7 <http://www.chathamfinancial.com/the-case-for-end-user-amendments/>

8 [http://businessroundtable.org/uploads/studies-reports/downloads/An\\_Analysis\\_of\\_the\\_Business\\_Roundtables\\_Survey\\_on\\_Over-the-Counter\\_Derivatives.pdf](http://businessroundtable.org/uploads/studies-reports/downloads/An_Analysis_of_the_Business_Roundtables_Survey_on_Over-the-Counter_Derivatives.pdf). Accessed January 6, 2011.

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