Betting the Business

Financial risk management for non-financial corporations

The Collateral Boogeyman is back

Victoria McGrane at the *Wall Street Journal*'s Real Time Economics blog **covers** the new **release** from Keybridge Research on the potential impact of collateral requirements that flow from the Dodd-Frank reform of OTC derivatives markets. The headline is "Study: Strict Derivatives Regulation Could Cost 130,000 Jobs". What is the substance behind those numbers?

The Keybridge release gets to its headline number in basically 4 steps:

1. Estimate the notional volume of derivative contracts outstanding at US companies (S&P500): $3,344.9 billion.

2. Apply a 3% factor to these trades as the estimate of the collateral required: $110.05 billion.

3. Assume this collateral requirement is a deadweight cash flow cost to the companies.

4. Estimate the impact of a drop in cash flow on capital expenditure and therefore jobs.

There are many potential points of contention in this calculation. But the big unexamined assumption is inside #3. There are two problems here–one micro and one macro.

The micro mistake is the delusion that absent a collateral requirement companies are able to trade derivatives at no cost to their balance sheet. This is plainly not true. If you don't back up your derivative trades with a cash collateral account, then you are backing them up with a promise that you are good for it, i.e. with credit. Companies have limited debt capacity, so using credit is costly, too. A regulation that requires using cash instead of credit costs the company on one side, but loosens its constraints on the other. The net effect on the company's free cash flow is zero. Keybridge's oversight here is a first order mistake. One could argue that the cash requirement is costlier than credit, but then you would have to figure out by how much. That would be an extra, very difficult step in the calculation, and any reasonable estimate for the differential would drive the headline number down enormously, possibly to zero.

The macro mistake is to ignore the entire purpose of the regulation. The collateral requirement is an indirect result primarily of the clearing requirement. The objective of this and other elements of the reform is to reduce the total risk in the system. Some of the reduction should come from canceling offsetting positions that simply add to total credit risk. Some should come from reducing systemic risk. It's always possible to ignore the systemwide purpose of a regulation and claim it is costly due to the burden it imposes on each transaction. You could do this for fire codes, for food and drug regulations and so on. But the only sensible way to examine the net impact of the regulations is to think through the full systemwide impact. One can have a good debate about whether or not the Dodd-Frank reforms will reduce the total risk in the system, and about what contribution a collateral requirement may make. But simply ignoring the systemwide impacts is not a useful contribution to reasoned debate on the matter.

Previous posts directly related to the micro issue include **this one** and **this one**. Previous posts on the macro issue include **this one**, **this one** and **this one**.

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