Berkeley Business Law Journal
Berkeley Center for Law, Business and the Economy

Financial Regulatory Reform: Dodd-Frank and Beyond

March 11, 2011
Panel One: Securitization & Governance

Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension

Erik F. Gerding, *University of New Mexico School of Law*

Both policymakers and scholars have placed considerable blame for the Panic of 2008 – the global financial crisis that reached full strength in that year – on over-the-counter ("OTC") derivatives. In turn, legislative and policy responses to the crisis, such as the Dodd-Frank Act, have introduced a host of new restrictions on these particular financial instruments. Among other things, the Dodd-Frank Act prohibits future federal government bailouts of certain entities that trade in derivatives, requires the central clearing of many derivatives, and authorizes federal regulators to set new collateral requirements for derivatives that are exempted from those central clearing requirements.

Yet, an analysis of both the role of derivatives in the financial crisis and the new rules governing derivatives, must avoid painting with too broad a brush. Several misconceptions threaten to confuse both the most serious risks posed by derivatives and the regulatory response. This article argues that a certain species of derivatives – credit derivatives – pose particular concerns because of their ability to increase leverage throughout the financial system. Credit derivatives are a form of derivative, whose value is based on the credit risk of another firm or financial instrument. However, the full economic consequences of the increased leverage from credit derivatives are often themselves not fully fleshed out. Many commentators have focused on how increased leverage, whether stemming from credit derivatives or otherwise, magnifies the fragility of financial institutions. To be sure, excessively leveraged financial institutions represent an important concern. Moreover, by linking one financial institution to another, credit derivatives can increase counterparty risk, or the risk of one party to a financial transaction defaulting on its obligations. The web created by financial institutions entering into complex credit derivatives with one another in series raises the specter of leveraged institutions falling like dominoes. The potential chain reaction of failing banks and other financial firms represents one form of system risk. It was this scenario that supposedly animated the extraordinary federal bailout of the insurance giant AIG, which had underwritten hundreds of billions of dollars in credit derivatives that proved guarantees to other large financial institutions. The looming failure of the firm left a myriad of other financial institutions with enormous exposure.

Yet this potential domino effect of counterparty risk is but one side of the coin of the consequences of credit derivatives and their ability to create leverage. What the above analysis, however briefly summarized, fails to capture are the macroeconomic effects of credit derivatives. This article aims to move beyond the analysis of the counterparty risk of derivatives to explore these macroeconomic effects. By allowing financial institutions – those institutions that borrow to lend – to increase leverage, credit derivatives can operate to increase the overall amount of liquidity in financial markets. This increase in liquidity can be thought of as increasing the overall supply of money in a market, which can have a number of significant economic effects. By increasing leverage and liquidity, credit derivatives can fuel rises in asset prices and even bubbles. Rising asset prices can then mask mistakes in pricing credit derivatives and in assessing the risk of leverage in the financial system. Furthermore, the use of credit derivatives by financial institutions can contribute to a cycle of leveraging and deleveraging in the economy.

This article seeks to explore and outline these macroeconomic effects of credit derivatives. In so doing, this article also argues for viewing many of the policy responses to credit derivatives, such as requirements that these derivatives be exchange-traded, centrally cleared or otherwise subject to collateral or "margin" requirements, in a second, macroeconomic dimension. These rules would affect not only counterparty risk and the safety and soundness of financial institutions, but also would have subtler, but significant macroeconomic effects. These rules have the potential to change the amount of liquidity and supply of credit in financial markets and in the "real" economy. Moreover, what is true for credit derivatives applies equally to other financial instruments and regulations (ranging from bank capital requirements to requirements that lenders

retain part of the loans they securitize) that can alter the leverage of financial institutions. By examining credit derivatives, this article illustrates the need to see a wide array of financial regulations in a macroeconomic context.

Understanding these macroeconomic effects also reveals a number of implications for regulatory design. First, regulations that address financial institution leverage offer central bankers new tools to dampen inflation in asset markets and to fight potential asset price bubbles. Second, even if these regulations are not used primarily as monetary or macroeconomic levers, changes in these regulations, including changes in the effectiveness of these regulations due to regulatory arbitrage, can have profound macroeconomic effects. Third, the macroeconomic dimension of credit derivative regulation and other financial regulation argues for a need for greater coordination between prudential regulation and macroeconomic policy. In providing concrete examples of how prudential regulation can have effects on the macroeconomy, this article fits into the burgeoning literature on "macroprudential regulation." Effective coordination, in turn, requires further integration in the academy of the study of financial regulation and macroeconomics. Coordination also requires greater consideration of macroeconomics in the legal academy.

This article proceeds as follows. Part I describes how credit derivatives function and how they can increase leverage. This Part summarizes scholarship on how leverage can lead to counterparty risk and domino failures of financial institutions and outlines criticisms of credit derivatives that represent "pure bets." Part II then argues that a second category of credit derivatives, those in which at least one party to a derivative is hedging a preexisting credit risk, poses a different kind of danger. These hedging credit derivatives can increase leverage and liquidity throughout financial markets, all the way back to consumer and commercial lending markets in the "real" economy. Hedging credit derivatives represent an important strand in the "shadow banking system," a network of financial institutions and instruments – including asset-backed securities – that grew in the last three decades to link borrowers to investors in capital markets. The shadow banking system provides the same credit function as traditional lending by depository banks, but bypasses many of the regulatory costs on those banks. Part III outlines the macroeconomic effects that these hedging credit derivatives can have, including increasing overall liquidity in financial markets, contributing to asset price booms and even bubbles, and magnifying leverage cycles. Part IV then discusses some of the implications of this macroeconomic dimension to credit derivatives for policy and scholarship.