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A PROJECT OF THE POLITICAL ECONOMY RESEARCH INSTITUTE ■ UNIVERSITY OF MASSACHUSETTS, AMHERST

United States Senate
Washington, DC 20510

May 14, 2010

**Letter from Joseph Stiglitz re. Section 716:
Prohibition Against Federal Bailouts of Swaps Entities**

Dear Members of the Senate:

I strongly support the passage of the derivatives and swaps regulation sections of the Senate Financial Reform Bill and especially Section 716 (“Prohibition Against Federal Bailouts of Swaps Entities”). If the Senate fails to pass strict regulatory oversight over dangerous over-the-counter derivatives and swaps, then the U.S. economy will continue to be vulnerable to significant financial risks.

Many economists agree that the unregulated, over-the-counter derivatives market played a key role in transforming a financial downturn into a global economic calamity. The derivatives regulation amendments that Senators Lincoln and Dodd have incorporated into the “Restoring Financial Stability Act of 2010” bring a critically important measure of regulation over dangerous derivatives and swaps products by requiring: exchange-trading and clearing of most standard derivatives; the prudential regulation of major swaps dealers, including capital reserves requirements and business conduct rules; the spinning off of risky swaps desks from the systemically risky banks; and the ability of regulators to ban swaps that lead to financial instability or have no economic purpose.

Of significant importance is Section 716 (“Prohibition against Federal Government Bailouts of Swaps Entities”) as part of the Dodd-Lincoln substitute to the Restoring Financial Stability Act of 2010. It, along with other structural reforms under consideration such as a statutory Volcker Rule (strengthened by the Merkley-Levin Amendment), will, I believe, sharply reduce the possibility of taxpayer bailouts for speculative activity that does not serve the real economy.

Section 716 is a flat ban on federal government assistance to “any swap entity,” especially in instances where that entity cannot fulfill obligations emanating from highly risky swaps transactions. Specifically, Section 716 bars “advances from any Federal Reserve credit facility, discount window...or [loan or debt guarantees by the] Federal Deposit Insurance Corporation.”

Section 716 will require the five largest swaps dealer banks to sever their swaps desks from the bank holding corporate structure. Those five banks are: Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Citigroup, and Bank of America, the institutions involved in well over 90 percent of swaps transactions. Under Section 716 a “swap entity” and a banking entity could not be contained within the same bank holding company, if the bank holding company has access to federal assistance.

By quarantining highly risky swaps trading from banking altogether, federally insured deposits (and our basic payments mechanism) will not be put at risk by toxic swaps transactions. Moreover, banks will be

forced to behave like banks, focusing on extending credit in a manner that builds economic strength as opposed to fostering worldwide economic instability.

Some prominent members of the Administration, including Sheila Bair, have come out in opposition to Section 716. Chairman Bair's concern was that forcing derivatives dealers out of banks would move the business into less regulated and more leveraged entities. While saying that banks should not engage in speculative activities, she argued that banks have an important role in creating markets for their customers who might need to hedge interest rate risks related to their core lending business. Chairman Volcker, too, took the position that providing derivatives is a normal part of a banking relationship with a customer and should not be prohibited.

These assertions are questionable. First, if the role of banks in selling derivatives is so important and if it is part of the usual course of a banking relationship, why is it that only five banks – J.P. Morgan Chase, Citibank, Bank of America, Goldman Sachs and Morgan Stanley - account for 90 percent of the market? Surely that kind of oligopolistic domination of the market makes clear that it is not an activity normally undertaken by banks. Moreover, the level of concentration among swaps dealers is, in itself, systemically risky in addition to being anti-competitive.

Second, separating swap dealing operations from the business of banking does not mean that banks will be unable to hedge their banking risks. Banks will not, for instance, be prevented from entering into swaps to hedge their interest rate risk on their loan portfolio. (Indeed, very few banks, other than the large Wall Street banks, will be affected directly by Section 716, which applies to swap dealers or major swap participants.) They will become end-users. Like other end-users, they can and presumably will use the exchange-traded futures market to hedge risk. If the present Senate provisions pass, it is estimated that ninety percent of this market will move from OTC swaps trading to the more transparent and capitalized exchange trading environment for futures contracts.

That should leave these banks with much less dependence on and exposure to the unregulated and risky OTC swaps market, but, to the extent they participate in the OTC market, they will do so with an interest in seeing that the dealers from whom they buy derivatives are well managed, well regulated and well capitalized. The burden of bank supervisors in ensuring that the bank is not excessively exposed to risk (including counterparty risk) will be commensurately reduced.

In addition, the largest dealers will be able to retain what for them has been a major profit center by moving their swaps desks into subsidiaries under the bank's holding company. Their only loss will be the inability to sell and trade without disclosing the prices they charge, since most of their business will be conducted through clearinghouses and exchanges, and subject to requirements for disclosure and reporting that off-balance-sheet, over-the-counter markets are designed to evade.

But, third, and perhaps most important, the assumption that taking derivatives desks out of banks will make the business less regulated and more leveraged is simply wrong. For one thing, the requirements for prudential oversight under Title VII of the bill will apply standards for capital adequacy, transparency, anti-fraud and anti-manipulation to stand-alone derivatives dealers. Each and every swap dealer

will be registered with and regulated by the CFTC. Each and every security-based swap dealer will be registered with and regulated by the SEC. But the equally important point is that they couldn't possibly be less regulated and less well capitalized than the bank dealers are now.

Chairman Lincoln's provisions have the enormous value of getting the vast dealing and trading operations in derivatives out of the shadowy off-balance-sheet world where they are now posted by the large bank and investment bank dealers. This will have very substantial systemic benefits for the derivatives market and for the banking and financial system as well. Increased transparency will lead to more competition and a more efficient marketplace for derivatives. It will also ensure a better capitalized derivatives market. In addition, it will shrink the enormous exposure of a few very large banks that can threaten the stability of other financial institutions and the many non-financial companies that use this market.

In short, there are several simple economic principles underlying Section 716. Transparency contributes to efficient and competitive markets. Less transparent (OTC) markets can be more easily manipulated. Swaps are effectively a form of insurance (when they are not just gambling instruments), and as such, there should be backed by adequate capital. It was clear that there was inadequate capital prior to the crisis on the part of at least some key players in the market. These flaws can contribute to a lack of confidence in these markets, and a lack of confidence can contribute to thinner markets and lead to more volatility.

So long as those financial institutions that have access to federal assistance (or are likely to have access in the event of a crisis) can write such contracts, the government is effectively underwriting these contracts. The market gets distorted in two ways: first, these institutions have a competitive advantage, not based on greater efficiency, but based on more likely access to government assistance. Second, the insurance is underpriced, because it is effectively subsidized (or, when these instruments are effectively used as gambling instrument, gambling through these instruments is encouraged). Subsidies, whether explicit or implicit, distort resource allocations and contribute to a less efficient economy. There are certain instances where the government might want to encourage certain economic activities, but those should be clearly articulated and narrowly circumscribed. I see no compelling reason why the U.S. government should be engaged in subsidizing credit default swaps or derivatives, whether they are viewed as risk management products or gambling instruments. On the contrary, to the extent that these products have shown that they can increase societal risk, with huge costs, these have demonstrable negative externalities, and a compelling case could be made for taxing them. The amendment does not go that far. It takes a far more modest step of ending the implicit subsidy.

The argument for restricting these activities of too-big-to-fail institutions should be obvious: no matter what legislation we write, it is baseless to suggest that we will not bail out these institutions should they face a problem. More likely than not, when a crisis occurs, we will bail them out—precisely because they are too big to fail. Living wills and resolution authority may help a little, but only a little. In the midst of a crisis, government, facing the potential downside risk of the demise of one of our too-big-to-fail banks, will likely come to the rescue. To believe that we have ended (or, when this bill is passed, we will have ended) the notion that a bank is too big to fail is simply foolish. And the markets share this view: the too-big-to-fail institutions can get access to funds at lower interest rates.

CDS's not traded through exchanges and clearinghouses can, indeed, exacerbate the problem, because the financial institutions can (accidentally or deliberately) become so intertwined that systemic risk is increased even further. Indeed, the problem could even arise with OTC's written by moderate-sized banks.

Without the kind of regulation provided by Section 716, CDS's and other derivatives undermine the workings of a market economy in two further ways. First, a basic principle of a market economy is decentralization: each firm can make its decisions based on the prices it faces. But under current arrangements, firm A has to assess the ability of firm B with whom it interacts to fulfill its contracts, and that requires that it know the CDS exposure of firm B. But to ascertain the risk faced by firm B, it must know all of firm B's CDS's counterparties (and the risks to which they are exposed), in an infinite web. Second, and related, there is widespread recognition of the importance of the "discipline of the capital market." But how can the capital market exercise discipline, if banks and other financial institutions are exposed to large non-transparent risks, including the complex counterparty risks just described? We saw in the crisis the massive failure of the ability of capital markets to exercise discipline over banks and AIG. By requiring trading on transparent exchanges and through adequately capitalized clearinghouses, Section 716 facilitates the ability of markets to provide the kind of discipline without which a market economy cannot effectively function.

Some end-users are worried that these reforms will raise their costs. To some extent, these end-users seem ill-informed. It is easy to see how more transparent and competitive markets would lower transactions costs, bringing substantial benefits to end-users. If it were the case that less transparent and less competitive markets brought benefits to end-users, much of conventional economics would have to be rethought. Even when the standardized products traded on exchanges do not precisely hedge a particular risk faced by a firm, modern finance theory has shown that one can construct a package of standardized product that can do so, and we have every confidence that some financial firms will provide those services.

Of course, to the extent that end-users are the beneficiary of an (implicit) subsidy from the government (through the potential bail-out), they will be hurt. So too, an insurance company that was not required to have adequate capital could provide insurance at a lower premium—which might benefit the buyers *in the short run*. But short run profits are increased at the expense of potential long run costs—for when the insured event occurs, the insurance company may not have the capital to deliver on its promises. (Problems in corporate governance and deficiencies in accounting might, of course, lead CEO's to advocate policies which increase short run profits, especially when their compensation is related to these short run profits, even when it is at the expense of the long run well-being of the firm.) Requiring adequate capital is necessary if insurance is to be appropriately priced in a competitive market.

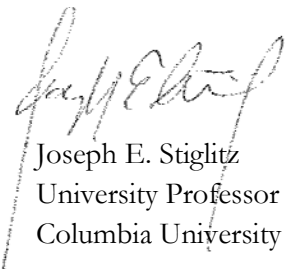
It is important to realize that restricting the too-big-to-fail banks from engaging in certain activities does not mean that these services will not be provided—though without the implicit subsidies, the extent to which they are used may be reduced. No evidence has been presented that there are sufficient economies of scope to offset the systemic risk to which current arrangements give rise. (And as we have noted, the fear that these activities will move to less well regulated has little merit.)

The current arrangements have thus not only contributed to greater economic instability, they resulted in some financial institutions imposing huge costs on the rest of the economy (massive negative externalities). Moreover, current arrangements have distorted our economy, leading to a less efficient economy, whose long run growth will be slower—possibly substantially slower—than it otherwise would have been. Section 716 will not prevent all the abuses and distortions just described, but it would be a big step in the right direction. Any ancillary costs are more than offset by the major benefits that it would bring to our economy.

Let me add a final comment on the risk that such derivative activities move abroad, reducing scope for regulatory oversight and putting our large banks (the five or so that issue the bulk of these derivatives) at a competitive disadvantage. First, the reforms provided by Section 716 will likely reduce the importance of derivatives as a profit center, precisely because they will make these markets more transparent and more competitive. Secondly, we should be focusing on the stability of the American financial system, not the profitability of particular banks (the vast majority of which are now swaps dealers). If our banks are required to buy (all or most of) their derivatives through exchanges or clearinghouses, then the counterparty risk will be reduced, and bank supervisors can then direct more of their attention to any remaining OTC products, including those purchased abroad, ensuring that they are adequately capitalized. It was apparent that the task of supervision was beyond institutional capacities before the crisis; narrowing what has to be supervised enhances the likelihood it will be done effectively. (If there is insufficient transparency or inadequate capital on the part of foreign issuers, regulators can simply ban the transactions or demand sufficient reserves on the part of the American bank to make the foreign transaction unattractive.) Section 716 would thus protect against the risk of another AIG in two ways: If American banks bought a derivative (such as a CDS) from a foreign financial institutions group (FIG), bank regulators would ensure that that FIG satisfied the standards of an American issuer and/or that the bank had set aside sufficient capital to deal with counterparty risk. And if the FIG failed, it would not be the responsibility of the American taxpayers to bail it out, but of the foreign government. The liabilities would not be put on the shoulders of American taxpayers. (We assume, of course, that bank regulators would ensure that the American banking system is never again exposed to the risk of a failure of a major provider of derivatives, whether foreign or domestic. If our regulators cannot do this, there is little hope that any legislation will protect us.)

In short, I urge you to defend the strict derivatives regulation language in the Senate Bill, including the important Section 716.

Sincerely,



Joseph E. Stiglitz
University Professor
Columbia University