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Deep Sixing Derivatives Reform: Stop the Cave In!

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Senator Dodd has filed an amendment to deep six a key component of the derivatives reform legislation that would prohibit banks from owning swaps desks in their core banking operations that are protected by tax payer guarantees. And Dodd is likely to succeed unless opposition mobilizes fast. Indeed, a filibuster could be the order of the day.

Dodd's Amendment (# 4110) would strip the Financial Reform Bill's "Prohibition Against Federal Government Bailouts of Swaps Entities" of its teeth, delay its implementation for two years while regulators "study" its impact and then send it up to be killed by the very regulators - Treasury Secretary Timothy Geithner, Fed Chair Ben Bernanke and FDIC Chairwoman Sheila Bair -- who have strongly opposed the legislation. According to Brady Dennis of the Washington Post, "The (Dodd) amendment calls for the new Financial Stability Oversight Council, made up of existing regulators, to study the impact of the Lincoln ban "on the swaps and security-based markets, including the effect of such prohibitions on central clearing and exchange trading of standardized swaps." Within a year, the council would report its findings, which are likely to be critical of the proposed rules because several members of the council have already expressed opposition to the proposal. The Treasury secretary, who would chair the council, has final say about whether to suspend or enforce the provision."

Burying Section 716 would be a significant blow to trying to rein in the dangerous practice of massive banks undertaking socially destructive activities with tax payer guaranteed funds. Section 716 bars "advances from any Federal Reserve credit facility, discount window...or [loan or debt guarantees by the] Federal Deposit Insurance Corporation" for risky swap dealers and would force the 5 large banks that control over 90% of the swaps market to place the bulk of their lucrative swaps selling business out of their core banking units or lose access to emergency government support facilities. This provision is simply an extension of the "Volcker Rule" that attempts to prevent banks from engaging in excessive gambling with tax payer supported money.

As we argued in a previous post, 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. Moving the selling and trading of these instruments into separate entities will increase transparency by bringing derivatives out of the shadows so that dealers can be more easily regulated and the prices and volume of purchases...
and sales in the market will be readily available to counterparties. It will also ensure a better capitalized derivatives market since, as the crisis revealed, there is so little capital backing for the off-balance sheet liabilities of the large banks where the majority of the business is still being conducted. 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.

Finally, it will make it less likely that tax payers will have to bail out these banks for making bad bets that fizzle. Failure to stop Dodd from stripping out 716 is a vote to perpetuate the cycle of "bet and bail", a cycle that has cost Americans and the world dearly.

So: deep six Dodd's #4110.