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Why Section 716 is the Indispensable Reform

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Dominated by the world's largest banks, the over-the-counter (OTC) derivatives market has been expanding since the break-down of the Bretton Woods Agreement in the early 1970s privatized the international monetary system by shifting the payments process from central banks to commercial banks. The proliferation of foreign exchange forwards and swaps that followed set in motion an ever-expanding menu of exotic instruments that reached a nominal value of over $600 trillion by the middle of the current decade. Central banks and financial regulators ignored the implications of the growth of this market and ignored warnings from the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) from 2002 forward that OTC derivatives were at the center of what had become a global casino in which the largest international institutions were the biggest speculators.

The large, international institutions that created the OTC market for foreign exchange forwards and swaps were commercial banks. Following established banking practice, they conducted their derivatives business like portfolio lenders rather than broker/dealers, buying and selling forwards and swaps outside of established markets. But OTC derivatives contracts can’t be classified as assets or liabilities until they are settled and can’t be held on banks’ balance sheets the way loans and deposits are held. Instead, they were booked off balance sheet as contingent liabilities. The market structure that emerged in what came to be the largest market in the global economy was one in which non-tradable contracts were bought by and sold to customers without real time information on volume or pricing or the aggregate positions of the dealers themselves. Moreover, the fact that the contracts were illiquid required constant hedging by dealers that expanded their positions and inflated the size of the market relative to all other national and international financial markets. Meanwhile, the commercial bank dealers’ derivatives business was operating with all the implicit guarantees and subsidies that governments put in place to protect this core financial sector. In 2008, those guarantees became explicit and were exercised.

Are there reasons to protect derivatives dealers?

Because the largest U.S. commercial banks were dominant players in the OTC derivatives markets, Federal Reserve lending, FDIC guarantees and taxpayer bailouts during the 2008 crisis gave explicit protection to both bank and non-bank swap dealers and major swap participants. Those protections are not grounded in the traditions and practices of U.S. financial law and regulation. They are no more appropriate than would be an extension of federal protection to financial entities...
(including bank affiliates) that market and trade corporate stocks and bonds. Recognizing how far the government’s response in 2008 deviated from the existing rational framework for government intervention, Section 716 of the Senate bill makes clear that such protections are not to be given statutory approval; that allowing banks to continue to deal and trade in derivatives would be to accept this egregious violation of prudential standards in legislation intended to reform and strengthen a fragile financial system.

The movement of the largest banks into the business of marketing and trading OTC derivatives occurred during a period when the process of deregulation was sweeping away traditional regulatory barriers and was not challenged. That fact should not, however, lead to the assumption that this is a “normal” banking activity. There is no economic or systemic reason why derivatives should be sold by banks. As the entry of large investment banks into the business in the 1980s suggests, it is not tied to the traditional deposit-taking and lending activities of banks or to the payments system. It is, in fact, so esoteric an activity that, currently, only five institutions account for 90 percent of the market. The remaining 8,000 or so U.S. banks do not sell derivatives or trade them for their own account.

Equally questionable is the assertion that dealing in derivatives is part of banks’ role as intermediaries; that they are helping to meet the hedging needs of their customers. As CFTC Chairman Gary Gensler recently pointed out, BIS data show that sales and trades with commercial end-users account for only eight to nine percent of the OTC market. Over 90 percent of contracts involve transactions between dealers or with other financial institutions. Meanwhile, the events of 2008 have made a mockery of the frequently voiced assertion that derivatives were invaluable in shifting risk to those most able to bear it – unless, of course, the assumption was that those most able to bear it were taxpayers.

Risk and fiduciary responsibility

Housing the business of marketing and trading derivatives in banks intensifies systemic risk and undermines fiduciary responsibility. Buying and selling OTC derivatives contracts is a zero sum game. Unlike portfolio lending that links the fortunes of borrowers and lenders, one party to a derivatives transaction wins while the counterparty loses. Given the nature of the game, dealers must constantly hedge their positions but, unable to do so by trading their side of the contract, their exposures grow higher and higher and include a number of contracts with long maturities. Systemic risk is embedded in this type of market structure – the more so since the buildup in these positions over the decade preceding the crisis depended on short-term borrowing and rising leverage. Touted as a way to defuse risk, the expansion of banks’ derivatives business actually intensified it.

The buildup in derivatives positions among the large dealers also created a new and dramatically intense form of systemic risk: interconnectedness. The share of total transactions accounted for by contracts between a relatively small group of dealers resulted in an increasingly symbiotic web of interdependence among the largest institutions in the global market. The size of individual dealers’ positions contributed to systemic risk but interconnectedness was at the epicenter of the problem.

What section 716 does to alleviate the problem

The most important element in section 716 is the structure it provides – one that makes a clear separation between the business of banking and that of marketing and trading derivatives. This structure makes it possible to protect the core financial functions of banks without extending those protections to cover highly risky derivatives transactions.

By requiring that dealing and trading derivatives move to separately capitalized affiliates that do not have access to Fed lending facilities or FDIC guarantees, section 716 will also contribute to shrinking the size of individual institutions’ positions and the market itself. The huge capital reserves of the five institutions that
that dominate the U.S. market will no longer be available to support their outsized positions. The capital of derivatives affiliates – even if within the same holding company – will necessarily be much smaller and will limit their aggregate positions. This will create opportunities for non-bank firms to enter the market with capital positions equivalent to those of the affiliates of major institutions.

By shifting the activity to affiliates, section 716 eliminates the burgeoning counterparty risk the largest banks incur through marketing and trading OTC derivatives. Encouraging an expansion in the number of dealers will help reduce the risk to the system as a whole. The intent in both the House and Senate bills to require clearing and trading on exchanges using a central counterparty structure is another critical element for alleviating interconnectedness but only if the pressure to create loopholes is resisted.

Are there other provisions that mitigate these risks if banks are allowed to continue selling and trading derivatives?

There are other provisions in the House and Senate bills that address some aspects of bank exposure to risks involving derivatives but none of them remove the government guarantee backing their marketing and trading by banks. For example, the Volcker Rule in section 619 of the Senate bill deals with the equally important problem of proprietary trading by proposing to bar trading in any financial instrument, including derivatives, for a bank’s own account. The Merkley-Levin amendment strengthens this provision by making the reform a statutory ban rather than leaving it to the discretion of regulators. In addition, it would crack down on trades that conflict with customers’ interests.

But Merkley-Levin is not a substitute for section 716. It would still allow banks to deal and trade on behalf of their clients. Their derivatives business would still be backed and subsidized by Federal Reserve lending and FDIC guarantees and, in the event of another crisis, might require taxpayer bailouts to protect the banking functions of these huge enterprises.

Other sections of the Senate bill – sections 608–611 – address the systemic risk posed by interconnectedness. Section 610 limits a bank’s credit exposure (including derivatives) to another bank or financial institution as a percentage of its capital. This provision will tend to shrink the OTC derivatives market since, as noted, over 90 percent of aggregate transactions involves trades between dealers or with other financial institutions. Another section (608) complements section 716 by limiting a bank’s credit exposure (including derivatives) to affiliates. But, again, banks would still be able to conduct their derivatives business within the bank and the government backing for the bank that constitutes a guarantee and subsidy for selling and trading derivatives would remain.

Both the House and Senate bills authorize regulators to impose aggregate position limits on traded contracts and swaps. These provisions complement both sections 610 and 716 in the Senate bill by allowing regulators to address excesses and imbalances in the derivatives positions of individual institutions and the aggregate market as well. They are a very important tool for strengthening the regulation of derivatives markets but – once more – they do not remove the anticompetitive government support uniquely enjoyed by the derivatives operations of the five largest U.S. financial institutions.

In summary, there are no substitutes for section 716 – no provisions that will accomplish what it does in terms of removing the subsidy enjoyed by (literally) a handful of institutions and ending the ongoing threat to the taxpayer that the guarantee of their derivatives business poses. Ignoring that threat would undermine all the other contributions to reform that the House and Senate bills provide.