May 13, 2010

Section 716: Economists Respond to Bernanke on Derivatives Bailouts

Dear Senators,

We write in response to the letter sent by Fed Chairman Ben Bernanke on May 12 to Senators Dodd, Shelby and Gillibrand concerning Section 716 of Senate Bill 3217, the Restoring American Financial Stability Act of 2010. The Fed Chairman claims that Section 716 is “….inconsistent with the important goals of financial reform legislation” and should not be approved. We take issue not just with his recommendation, but also with his description of what the bill actually provides.

For example, Chairman Bernanke’s letter erroneously claims that five of the nation’s largest banks (Goldman, JP Morgan, Morgan Stanley, Citibank, and Bank of America), who now control 90% of the multi-trillion-dollar swaps market, will be deprived of access to federal taxpayer assistance for their highly risky (and already heavily bailed out) swaps practices, because Section 716 prevents “insured depository institutions from hedging their own risks,” including “interest rate, currency, and credit risks.” This statement misconstrues the intent of the Lincoln/Dodd bill. If the bill passes in its present form, including Section 716, it would allow those banks to use highly transparent and fully capitalized exchange-traded instruments, which would come to constitute 90% of the hedging market, allowing them to hedge all their banking risks. Thus, most institutions hedging risks would be using the much safer and more transparent exchange-traded futures systems; our systemically risky banks should be required to do the same.

Moreover, these big banks would still also be able to use negotiated highly customized non-standard swaps to hedge risks. Those swaps, which would be negotiated as to every material economic term, would be available to banks for hedging, and still not deprive them of access to the Fed window. By using these two kinds of instruments, i.e., exchange-traded futures and fully negotiated swaps, these banks would have a very limited need for over-the-counter, standardized, but uncleared, swaps. Banks would therefore fall below the “major” swaps participant threshold, and as mere “swaps participants” would be eligible for Fed window relief.

Chairman Bernanke’s fear that these big banks will “not be able to meet the hedging needs of their customers” also rings hollow. Senator Lincoln has made clear that the banks may keep within their corporate infrastructure wholly independent and separately capitalized swaps-dealing affiliates which can service bank customers’ needs. To be sure, those activities will not be eligible for federal taxpayer assistance; but that limitation imposes the very discipline that will keep the toxicity of these transactions in check. In short, the banks may market swaps to their customers; they just cannot do so with the American taxpayer as their safety net.
Even if swaps dealers were moved completely out of the bank holding company infrastructure into independent institutions, Chairman Bernanke himself acknowledges that, under the Dodd/Lincoln regulatory template, “all swaps dealers and major swap participants [wherever located] are subject to strong capital, margin and collateral requirements with respect to the swap activities.” He conveniently overlooks this fact when he argues elsewhere in his letter that “[f]orcing these activities out of insured depository institutions would weaken . . . strong prudential regulation of derivative activities.” That statement not only defies Chairman Bernanke’s earlier admission that these institutions are to be separately and fully regulated, but also ignores the plain language of the Lincoln/Dodd bill, which, for the first time calls for major swaps institutions to be fully regulated for capital adequacy and prudential conduct wherever they are located within the financial sector.

Finally, Chairman Bernanke’s desire to allow “clearing agencies and derivative clearing organizations” to have access to federal assistance flies in the face of arguments to the contrary by FDIC Chairman Sheila Bair and CFTC Chairman Gary Gensler, both of whom have made clear that these clearing facilities also need the discipline of knowing that the taxpayer will not bail them out if they do not act with the highest degree of prudence as separately regulated institutions outside of the bank holding company infrastructure.

By urging continued taxpayer support for all of these highly risky and uncleared transactions, Chairman Bernanke is trying to sustain an environment in which American citizens continue to be the lender of last resort to those very institutions and transactions that caused the current chaotic worldwide economic environment, in which one in six Americans is unemployed or underemployed and almost everyone (except highly compensated employees of these big banks) faces a future of heightened economic insecurity.

The moral hazard of taxpayer bailouts has to end. Moving swaps dealing out of federal taxpayer assistance imposes a discipline that ensures that this highly risky and toxic trading will, in the future, be done more carefully and prudentially, with full knowledge that failure really means failure and not a taxpayer bailout.

Sincerely,

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