

Derivatives Reform: Reducing Systemic Risk, But at What Cost?

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Executive Summary

The financial reform bills now on their way into the Congressional conference committee process include a series of strong new measures aimed at addressing systemic risks posed by derivatives. While several of the most prominent provisions would represent constructive steps if properly implemented, legislators and the press have paid too little attention to the costs that the new derivatives rules will impose on financial institutions and non-financial companies, the effect that the new rules will have on the price and availability of credit, and the impact the new rules would ultimately have on U.S. consumers and the economy as a whole.

This paper highlights some of the direct financial costs and secondary consequences associated with the new rules, which will remake the structure of U.S. and global derivatives markets even if, as expected, the conference committee eliminates the onerous mandate that banks spin-off their derivatives businesses. It also calls attention to the uncertainty already emerging among companies and financial institutions due to the often ambiguous language included in the bills. The lack of specificity in several major provisions will grant regulators an unprecedented degree of latitude to determine how the new law will be interpreted and applied, and even to decide which individual companies will be bound by the new rules and which will be exempt.

Key Provisions

Members of the now-forming Congressional conference committee on financial reform will have their hands full reconciling the different provisions approved by the U.S. House of Representatives and Senate on a series of contentious issues including the process for handling future failures of large financial institutions, the proposed separation of proprietary trading and banking business. We should expect less debate in the area of derivatives, where legislators are broadly in agreement over many of the central issues and — with a few exceptions — the major provisions in the Senate version will likely hold sway. The bill passed last week by the Senate would enact the following changes to the regulatory structure for the trading of derivatives. It would:

- Require mandatory clearing and exchange trading for certain swaps transactions, empowering the CFTC and/or the SEC to determine which transactions will fall under the requirement. Both the Senate bill and the bill passed by the House contain exemptions for non-financial end-users employing swaps to hedge commercial risks, with the House exemption generally viewed as being broader and less restrictive. In the Senate version, public companies claiming this exemption

would first be required to obtain approval from their audit committees and the exemption would only apply to transactions that qualify for hedge accounting treatment.

- Allow the CFTC and SEC to set new capital and margin requirements for swaps dealers and major market participants, with higher requirements imposed for transactions not cleared through central “derivatives clearing organizations.”
- Require derivatives dealers and major market participants to register with the CFTC, impose new reporting and record keeping requirements for all non-cleared transactions and set new standards for business conduct and back-office operations.
- Impose position limits for certain swaps transactions.
- Create segregation requirements for collateral in swaps cleared through central derivatives clearing organizations and allow counterparties to non-cleared transactions to request segregation of assets with a third party.
- Grant regulators strong new enforcement powers in the area of derivatives, including the ability of regulators to act against fraudulent transactions or any transaction deemed to pose a risk to general financial stability.
- Impose fiduciary responsibility on swaps dealers in transactions with municipalities and other government agencies, pension plans, endowments, and retirement plans.

The House and Senate bills do differ on one key issue: the Senate provision that would prohibit government assistance to any derivatives dealer, clearing organization or any other major market participant. Because this rule would prohibit any of these entities from utilizing access to the Fed discount window and exclude them from federal deposit insurance coverage, it would require banks to spin-off derivatives operations into separately capitalized affiliates. This controversial provision is not part of the House legislation. Furthermore, the measure is opposed by most important players in Washington D.C. — including Rep. Barney Frank, who will lead the House delegation in the conference committee — and will likely be jettisoned from the final law.

Assessing the Costs of Stricter Regulation

Over-the-counter derivatives trades played a prominent, if poorly understood, role in the global financial crisis. In the subsequent push for reform, politicians and the press are rightly focusing on potential systemic risks in the current market structure. As such, extending government oversight to this massive and previously lightly regulated market is an important part of efforts to update and strengthen the U.S. financial regulatory framework. But much less attention is being paid to the important role that derivatives have come to play in financial markets as a primary means of hedging risk and the question of why markets evolved as they did. Even less is being said about how costs associated with new regulation will affect companies, consumers and the economy at large.

The new regulations soon to be debated by the Congressional conference committee would impose significant new costs on financial and non-financial companies alike. Those costs — which include both direct financial costs and costs associated with limits or changes to current hedging practices — will reduce the availability of credit and increase the cost of capital for U.S. companies. Eventually, these costs will be passed on to consumers.

The fact that regulation will impose costs that will eventually have a negative impact on the U.S. economy is not reason in itself to oppose legislation. To the contrary, virtually all the landmark pieces of legislation that have created the current U.S. market structure have imposed immediate costs on banks and clients, and most have been opposed by the financial industry on precisely those grounds. Following the events of the past two years, however, there is nearly unanimous consent among market participants that existing regulations must be made more effective.

Nevertheless, the costs of new regulations must be considered when weighing the merits of legislation — especially when those regulations cover an area as complex and important as derivatives. Costs must be taken into account when determining overall regulatory goals and in identifying the best and most effective means of achieving them. To this point, robust discussion of costs has been conspicuously absent in the Senate debate. The following sections highlight some of the potential costs and consequences that should be considered before the final legislation is enacted.

Centralized Clearing and Exchange Trading

The centerpiece provision of new derivatives regulation would shift the clearing of swaps transactions to “derivatives clearing organizations” and the trading of these instruments to exchanges. The primary goal of this initiative is to move risk from the balance sheets of individual banks and market participants to central entities where it can be aggregated, netted out and mitigated through the

imposition of margin and capital requirements. Most market participants agree that the move to centralized clearing would be a constructive step in managing systemic risk in derivatives markets.

However, achieving this goal will require unprecedented levels of standardization in derivatives contracts. This standardization could prevent companies from customizing derivatives agreements to the precise specifications of their liabilities. If it does, it will create mismatches that could actually increase risk and volatility in company P&Ls by reducing the effectiveness of hedges or even eliminating companies’ ability to hedge some risks. Also, by creating such mismatches, the bill could prevent some derivatives from qualifying for treatment as hedges under current U.S. accounting rules. These derivatives would become subject to mark-to-market accounting standards, which would introduce significant levels of volatility to corporate P&Ls, effectively preventing their use in many cases.

This move will create additional new, first-order costs, including:

- Market participants will be forced to incur the administrative costs of setting up and maintaining margin accounts with “derivatives clearing organizations”;
- Market participants will be forced to use assets for collateral payments, both at the time of the initial transaction and with every significant change in market valuations. The redeployment of assets as collateral will reduce overall investment returns for asset managers, and thereby, for their pension fund clients, and reduce profit margins for non-financial companies;
- Even companies that qualify for the “commercial end-user” exemption will face higher costs. The shift to central clearing and exchange trading would reduce activity and liquidity in the OTC market. Significant new costs will be added to the system for all participants if banks are forced to use centrally cleared and exchange-traded derivatives to lay off risks incurred in the facilitation of OTC trades for exempt end-users.

Finally, the establishment of central “derivatives clearing organizations” could well create a false sense of security among regulators and market participants alike. The switch to central clearing will not eliminate risks in the derivatives market; rather, it will move risks from the balance sheets of individual banks to the central clearinghouses. Of course, the alteration in market structure should help better manage risks on a system-wide basis. Initial contributions from clearinghouse members would provide an immediate collateral cushion against defaults, and members would be forced to provide increased amounts of collateral as market prices fluctuate or default levels rise.

While these protections would lessen the odds that any individual bank failure could pose a risk to the system, there is no guarantee that member collateral contributions would be able to keep up with margin calls and overall capital demands in the event of a market-wide crisis. In such an event, the clearinghouse itself would undoubtedly represent a systemic risk. The current legislation is unclear on how that meta-risk should be handled: The Senate bill would give derivatives clearing organizations the lifeline of access to the Federal Reserve discount window. But members of the House have expressed concerns that this access could represent a new backdoor channel for bank bailouts if large financial firms acquire significant ownership stakes in the clearing organizations. The House bill contains ownership limitations intended to avoid that risk.

Position Limits

As noted earlier, the ambiguous language used throughout both bills gives extraordinary leeway to regulators who will be empowered to interpret and apply less-than-specific rules and definitions as they see fit. Nowhere is this concern greater than in the area of position limits. The Senate bill empowers the SEC to set position limits and orders “swap execution facilities” to reject any trade that would cause a customer to exceed those limits. This provision is aimed at preventing speculation in energy markets — a perennial bugaboo of politicians looking to explain why energy prices sometimes rise while they are in office. The position limit provision meant to address this phantom issue is at best heavy-handed and at worst, due to the lack of specificity about how position limits would be determined and implemented, could devolve into government price fixing.

Separation of Banking and Derivatives Trading

There is less reason for concern about another controversial part of the current bill: the proposal that would, in effect, prohibit banks with access to the Federal Reserve discount window or deposits secured by the FDIC from directly trading derivatives. This “spin-off” provision would ultimately force banks to establish separate subsidiaries for derivatives trading. The worst-kept secret in Washington is that this provision is not expected to be included in the final law, and that it was accepted into the Senate bill only as a means of burnishing Congress’ “tough on banks” credentials. The provision is opposed (or at least not supported) by Treasury Secretary Timothy Geithner. Federal Reserve Chairman Ben Bernanke thinks it would actually “weaken” financial stability. Also actively speaking out against the spin-off provision have been FDIC chair Shelia Bair and presidential advisor Paul Volker. While it’s likely that the provision will be dropped during the conference committee process, it seems incredible to non-Washingtonians that the Senate would allow for such naked and risky gamesmanship in legislation of such critical importance to the financial security and economic health of the nation.

Fiduciary Requirement

It is difficult to assess the potential costs and benefits of a proposal included in the Senate bill that would require derivatives brokers to act as fiduciaries in transactions with municipalities and other government agencies, pension plans, endowments, and retirement plans. The reason: It is impossible to envision how such a requirement would work. By definition, the two sides of a swap transaction have conflicting interests. While increased transparency and tough disclosure rules about potential conflicts of interests make sense as constructive methods of protecting market participants, the fiduciary requirement as it currently exists in the bill seems just short of nonsensical. Yet the provision remains in the Senate bill, and it remains to be seen how this provision will be reconciled with the House bill, which does not directly refer to derivatives markets, but does seek to extend fiduciary responsibility to any broker offering “personalized” advice to retail customers.

Conclusion

It is not only banks and other derivatives market participants that should be considering how the primary costs and secondary consequences of proposed derivatives rules will affect their businesses. Because of the central role that derivatives play in the U.S. banking system and in global financial markets, costs imposed by new regulations will have a far-reaching impact on banks’ ability to lend, the price and availability of credit for companies and consumers, and on companies’ ability to protect their bottom lines against volatility in commodities and financial markets.

To date, debate over the new rules has focused almost exclusively on uncovering the role that derivatives played in the global market crisis, the risks derivatives pose to the financial system and the allegedly unscrupulous behavior of derivatives dealers. While these are all important issues to address, they must be balanced by an objective look at the purpose derivatives serve in the modern financial system and the costs that will be imposed on markets and the economy in exchange for tighter regulation.

Some of those costs are immediately apparent, such as increased prices for market participants and their customers and the possibility of a serious degradation of companies’ ability to hedge risks. Other consequences are more difficult to quantify but potentially even more troubling. Because the proposed new regulations are written in language that is overly broad and at times ambiguous, the legislation if passed will vest regulators with unprecedented power to rule on the treatment of individual products and firms. The uncertainty that this situation will create — in addition to the potential for arbitrary or politically influenced rulings — constitutes perhaps the biggest negative consequence for markets and the economy.

Issues to Watch

- How will the government define “major market participants?”

As currently written, the label would apply to any entity that maintains substantial positions in swaps for purposes other than hedging, any entity that hold positions large enough to be deemed systemically risky by regulators and to any financial company that maintains substantial swaps positions and is also highly leveraged. Left unsaid is precisely how regulators will determine whether any given position is large enough to constitute a “substantial position,” or whether a given counterparty exposure could potentially have “adverse effects on the stability of the U.S. banking system or financial markets.”

Likewise, how will regulators determine whether an entity is “highly leveraged?” Where will they get the financial data needed to assess this question? Even when they use updated balance sheet information, by what standard will they decide if an entity’s leverage levels make it “highly leveraged?” Will this standard vary by type of company/institution? By industry?

As these questions show, the bill is ambiguous enough to allow regulators broad leeway and includes language that will allow the CFTC and the SEC almost unchecked discretion to finalize these definitions over time.

- How will the government define “commercial end-users?”

The Senate rejected an amendment that would have broadened the definition of “commercial end-user” to one more in line with that contained in the House bill. Currently, the language of the Senate bill defines a “commercial end-user” as any non-financial entity that “as its primary business owns, uses, produces, processes, manufactures, distributes, merchandises, or markets goods, services, or commodities (which shall include but not be limited to coal, natural gas, electricity, ethanol, crude oil, gasoline, propane, distillates, and other hydrocarbons) either individually or in a fiduciary capacity.”

The bill specifically excludes from the exemption all financial companies, which it defines as a swaps dealers/major market participants, entities “primarily engaged in activities that are financial in nature,” commodities pools or private funds.

Again, the non-specific nature of these definitions will allow regulators expansive authority to determine and limit the types of companies that will qualify for the exemption under the definition of a “commercial end-user.” This ambiguity is already causing concern among companies that see themselves as “on the bubble,” including insurance companies, which may or may not be considered financial companies under the bill’s current language.

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6 High Ridge Park Stamford CT 06905 USA

Tel: +1 203.625.5038/+1 800.704.1027

Fax: +1 203.625.5126

email: ContactUs@greenwich.com

www.greenwich.com