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Frank, Peterson Vow to Eliminate Provision Keeping Swaps Opaque

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By Matthew Leising

March 1 (Bloomberg) -- Congressional leaders are vowing to eliminate a provision in legislation passed by the House in December that would allow banks to keep the private derivatives market opaque, protecting billions in profits on swap trades.

Barney Frank and Collin Peterson, chairmen of the Financial Services and Agriculture Committees respectively, indicated they'll remove a section of the bill that allows trades to be routed through systems that keep prices private, even though the legislation was touted as a way to make the transactions transparent.

Congress is attempting to bring more oversight to Wall Street after largely unregulated bets tied to the subprime mortgage market helped spur the bankruptcy of Lehman Brothers Holdings Inc. and a $182.3 billion U.S. bailout for American International Group Inc. Private derivatives complicated efforts to solve the crisis by making it hard to know how interconnected banks had become.

Trades that don't have to be done on exchanges or electronic-trading systems are more lucrative because when investors don't have access to a range of prices, banks can preserve the gap between the price they pay to buy swaps and how much they charge to sell them. That so-called bid-ask spread boosts revenue for banks in the OTC market.

$35 Billion

The five largest U.S. derivatives dealers, including JPMorgan Chase & Co., Goldman Sachs Group Inc. and Bank of America Corp., were on pace through the third quarter to record as much as $35 billion in revenue last year from trading unregulated derivatives contracts, according to company reports collected by the Federal Reserve and people familiar with banks' income sources.

"The banks obviously have a desire to maintain the status quo," said Craig Pirrong, a finance professor at the University of Houston. Weak competition in derivatives markets and a lack of transparency help boost their earnings, he said. "Superior access to price information in a relatively opaque 'search' market can be quite profitable."

JPMorgan spokesman Justin Perras, Goldman Sachs spokesman Michael DuVally and Scott Silvestri of Bank of America declined to comment on the legislation.

Non-public confirmation systems, such as bank-owned MarkitServ, verify trade details for privately negotiated swaps without increasing transparency, a goal of the legislation.

Certainty on Trades

Confirmation systems are electronic networks used to verify trade details between private parties to a swap negotiation such as banks and their customers. The information is not publicly disclosed, unlike prices on derivative exchanges.

The House passed a provision Dec. 11 that requires the Commodity Futures Trading Commission and Securities and Exchange Commission to write rules to allow the trading of swaps that are "executed, reported, recorded, or confirmed in accordance with the rules of the designated contract market or swap execution facility."

Steve Adamske, a spokesman for Frank, a Massachusetts Democrat, said in an interview that changes to the wording will be sought either in the process to reconcile the House and Senate bills or by the Senate as it drafts its plan.

'Improve the Language'

Senator Christopher Dodd, chairman of the Senate Banking Committee, said Feb. 26 that Senate negotiators are close to a deal on the final legislation while declining to set a date for its release.

"We will support Chairman Peterson's statement to improve the language," Adamske said.

The broadened leeway for trade execution in the House bill clashes with what Gary Gensler, chairman of the Commodity Futures Trading Commission, says the markets need.

"Transparency is absolutely critical," Gensler said in January at the Council on Foreign Relations in New York. Regulated exchanges or computerized trading systems would enable investors to obtain better price information, he said. He didn't mention confirmation or reporting systems for trades.

'Maximize Profits'

"Primarily the five or six largest Wall Street firms" are opposing making the changes to the trading structure, he said. "They have a fiduciary duty to their shareholders to maximize profits. The information advantage is theirs right now. We shift that to a market-based structure, it lowers" profits, he said.

Told of Frank and Peterson's plan, Gensler said in a statement e-mailed Feb. 25, "I am hopeful that Congress will enact consistent regulations that will require as many derivatives transactions to be executed on exchanges or other trading facilities as possible."

The rules passed by the House apply only to trades involving products such as credit-default or interest-rate swaps that will be sent to clearinghouses, which help contain losses if a bank or major investor defaults.

Over-the-counter derivatives such as interest-rate, currency and credit-default swaps allow investors to hedge or speculate on changes in underlying assets such as interest rates, currencies or the ability of a company to repay its debt. The unregulated $605 trillion market is used by banks, institutional investors and corporations.

Discourage Banks

Some swaps users want to preserve the current system, Pirrong said. Companies that buy and sell over-the-counter derivatives like the flexibility of being able to customize trades over the telephone, he said.

Moreover, excess transparency in swaps markets may discourage banks from brokering the contracts and hurt how actively the products trade, Pirrong said. Other parties who know a dealer has accumulated a large position may trade against that broker, he said.

The House language on the "swap execution facility" originated in the Agriculture Committee, which passed its bill on Oct. 21. It mirrors a provision in a prior draft, written by Frank for the Financial Services Committee, that was removed after criticism that it maintained the status quo and didn't help make the markets more transparent.

The provision contains language that supersedes trading requirements mandated in other parts of the legislation, creating rules for swaps that can be processed by a clearinghouse. Section 2(k) requires that contracts "shall not be traded except on or through a board of trade designated as a contract market" or "on or through a swap execution facility."

Markit, DTCC

The part of the legislation Frank and Peterson vowed to cut includes the clause "notwithstanding section 2(k)," so it supersedes the execution rules.

The largest confirmation service in the OTC derivatives industry is MarkitServ, a partnership between Markit Group Ltd. and the Depository Trust & Clearing Corp. Markit, a derivative data provider, is majority-owned by banks including JPMorgan Chase, Bank of America, Royal Bank of Scotland Group Plc and Goldman Sachs.

The DTCC is owned by a group of investment banks, broker dealers, the National Association of Securities Dealers and the New York Stock Exchange.

--With assistance from Alison Vekshin in Washington and Shannon D. Harrington in New York. Editors: Richard Bedard, Alan Goldstein

To contact the reporter on this story: Matthew Leising in New York at mleising@bloomberg.net.

To contact the editor responsible for this story: Alan Goldstein at agoldstein5@bloomberg.net.