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The Economists' Committee for Stable, Accountable, Fair and Efficient Financial Reform

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Passing the Lincoln Amendment Gets at a Root of the Crisis

In this letter to the Senate, a dozen prominent economists express their support of Section 716 of the Financial Reform Bill, which would Prohibit federal bailouts of swap & derivative dealers

Dear Senators and staff:

The undersigned members of the Economists' Committee for Stable, Accountable, Fair and Efficient Financial Reform (S.A.F.E.R) strongly support the passage of the derivatives and swaps regulation sections of the Senate Financial Reform Bill and especially Section 716 ("Prohibition Against Federal Bailouts of Swaps Entities"). If the Senate fails to pass strict regulatory oversight over dangerous over-the-counter derivatives and swaps, then the U.S. economy will continue to be vulnerable to significant financial risks.

Many economists agree that the unregulated, over-the-counter derivatives market played a key role in transforming a financial downturn into a global economic calamity. The derivatives regulation amendments that Senators Lincoln and Dodd have incorporated into the "Restoring Financial Stability Act of 2010" bring a critically important measure of regulation over dangerous derivatives and swap products by requiring: exchange-trading and clearing of most standard derivatives; the prudential regulation of major swaps dealers, including capital reserves requirements and business conduct rules; the spinning off of risky swaps desks from the systemically risky banks; and giving regulators the ability to ban swaps that could lead to financial instability or have no economic purpose.

Of significant importance is Section 716 ("Prohibition Against Federal Government Bailouts of Swaps Entities") as part of the Dodd-Lincoln substitute to the "Restoring Financial Stability Act of 2010." It, along with other structural reforms under consideration such as a statutory Volcker Rule (strengthened by the Merkley-Levin Amendment), will sharply reduce the possibility of taxpayer bailouts for speculative activity that does not serve the real economy.

Section 716 is a flat ban on federal government assistance to "any swap entity," especially in instances where that entity cannot fulfill obligations emanating from highly risky swaps transactions. Specifically, Section 716 bars "advances from any Federal Reserve credit facility, discount window...or [loan or debt guarantees by the] Federal Deposit Insurance Corporation."

Section 716 will require, the five largest swaps dealer banks to sever their swaps desks from the bank holding corporate structure. Those five banks are: Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Citigroup, and Bank of America--the institutions involved in well over 90 per cent of swaps transactions. Under Section 716 a "swaps entity" and a banking entity could not be contained within the same bank holding company, if the bank holding company has access to federal assistance.

By quarantining highly risky swaps trading from banking altogether, federally insured deposits will not be put at risk by toxic swaps transactions. Moreover, banks will be forced to behave like banks, focusing on extending credit in a manner that builds economic strength as opposed to fostering worldwide economic instability. Finally, the spun-off swaps entity will be sufficiently isolated to permit the kind of careful prudential oversight mandated by Title VII of the Act as a whole. Title VII ensures that the spun-off entities will be regulated as institutions under the most rigorous prudential standards, and that almost all of the swaps instruments will be subject to standards for capital adequacy, full transparency, anti-fraud and anti-manipulation.

Some prominent members of the Administration, including Sheila Bair, Chairman of the FDIC, have come out in opposition to section 716. Chairman Bair's concern was that forcing derivatives dealers out of banks would move the business into less regulated and more leveraged entities. While saying that banks should not engage in speculative activities, she argued that banks have an important role in creating markets for their customers while needing to hedge interest rate risks related to their core lending business. Chairman Volcker, too, took the position that providing derivatives is a normal part of a banking relationship with a customer and should not be prohibited.

These assertions are questionable. First, if banks' roles in selling derivatives is crucial and part of the usual course of a banking relationship, why is it that only five banks - J.P. Morgan Chase, Citibank, Bank of America, Goldman Sachs and Morgan

Stanley - account for 90 percent of the market? Surely that kind of oligopolistic domination of the market makes clear that it is not an activity normally undertaken by banks. Moreover, the level of concentration among swaps dealers is, in itself, systemically risky in addition to being anti-competitive.

Second, separating swap dealing operations from the business of banking does not mean that banks will be unable to hedge their banking risks. They will become end users, and, as will be true of almost all other end users, they will use the exchange traded futures market to hedge risk. If the present Senate provisions pass, ninety per cent of this market will move from over-the-counter swaps trading to the more transparent and capitalized, exchange trading environment for futures contracts.

That should leave these banks with much less dependence on the unregulated and risky over-the-counter swaps market, but, to the extent they participate therein, they will do so with an interest in seeing that the dealers from whom they buy derivatives are well managed, well regulated and well capitalized. In addition, the largest dealers will be able to retain what for them has been a major profit center, by moving their swaps desks into subsidiaries under the bank's holding company. Their only loss will be the inability to sell and trade without disclosing the prices they charge, since most of their business will be conducted through clearinghouses and exchanges, and subject to requirements for disclosure and reporting that off-balance-sheet, over-the-counter markets are designed to evade.

But third, and perhaps most important, the assumption that taking derivatives desks out of banks will make the business less regulated and more leveraged is simply wrong. For one thing, the requirements for prudential oversight under Title VII of the bill will apply standards for capital adequacy, transparency, anti-fraud and anti-manipulation to stand-alone derivatives dealers. But the equally important point is that they couldn't possibly be less regulated and less well capitalized than the bank dealers are now.

In sum, 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. This will have very substantial systemic benefits for the derivatives market and for the banking system as well. 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.

In short, we urge you to defend the strict derivatives regulation language in the Senate Bill, including the important section 716.

Sincerely,

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