Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

QUESTIONS AND ANSWERS ON HR 992

What Does HR 992 Do?

HR 992 modifies Section 716 of the Dodd-Frank Act to add numerous additional exemptions to the section's ban on Federal government bailouts of large derivatives dealers.

What Does Section 716 Do?

The key effect of Section 716 as currently written is that it would force many types of swaps dealing activities to be removed from insured depository institutions and placed into a separately capitalized subsidiary. This is because Section 716 prohibits public (taxpayer) support for derivatives dealing, and insured depository institutions are automatically eligible for substantial public support. This support includes access to the Federal Reserve discount window as well as FDIC deposit insurance.

Section 716 already contains exemptions to the broad ban on public support that permit dealing in interest rate swaps and foreign exchange swaps to remain within the depository institution. Any derivatives needed to hedge actual banking activities may also remain within the depository institution. However, dealing in more exotic swaps – including equity swaps, many commodity swaps, and all customized credit default swaps -- would have to be conducted in a separate subsidiary completely supported by private capital and not eligible for the public support given to depository institutions.

How Exactly Does HR 992 Modify Section 716?

The exemptions added by HR 992 would allow almost all of the forms of swaps dealing 'pushed out' of the depository institution by Section 716 to instead remain in the depository institution. These swaps dealing activities would once again be supported by the public safety net, including Federal Reserve and deposit insurance support. This reverses most of the effect of Section 716.

What Banks Are Affected By Section 716 And HR 992?

The activity of swaps dealing is dominated by a few large Wall Street banks. Swaps dealing is the activity of 'making a market' in swaps, or selling derivatives to all sides in the entire market of users. Swaps dealers generally maintain large derivatives books and are dominant players in the relevant market. Community banks are not swaps dealers.

Some of the major Wall Street swaps dealers (such as Goldman Sachs) already do not conduct their swaps dealing activities from a U.S. insured depository institution. Thus they would not be affected by Section 716 or benefited by HR 992. The major banks that would likely be benefited by HR 992 are Citibank, JP Morgan, and Bank of America.

How Would These Banks Be Benefited By HR 992?

When banks can put their swaps dealing activities in a depository institution, they can engage in these activities more cheaply due to implicit public support. The business benefits from the cheap funding provided by insured deposits, and counterparties are confident that an insured depository institution will not default on swaps obligation. When swaps dealing is conducted from an independent subsidiary, counterparties demand more capital and collateral to be confident in the safety of the transaction. The costs of the activity more accurately reflect the true market risks of derivatives dealing.

Doesn't HR 992 Actually Maintain The Ban on Public Bailouts in Section 716?

HR 992 does not remove the explicit ban on public bailouts of swaps entities in Section 716(a). However, by greatly expanding the list of exemptions to that ban in Section 716(d) the legislation would take away most of the practical impact of the ban. Placing exotic swaps back into the depository subsidiary effectively restores the public subsidy to dealing in these swaps.

If Swaps Dealing Is Removed From The Depository Bank, Will It Go Unregulated?

No. All swaps dealers, including all non-bank dealers, are regulated directly by either the SEC or the CFTC. In addition, if a swap dealer is a non-depository subsidiary of a bank holding company it will be subject to Federal Reserve consolidated supervision. Finally, swaps dealers who are outside of a depository institution are subject to more effective market discipline and oversight. Counterparties will demand higher levels of capital and other protections when the dealer is not an insured depository.

Won't The Volcker Rule Protect Banks From Derivatives Risks?

Once implemented the Volcker Rule should protect banks from risks involved in proprietary trading. However, the Volcker Rule specifically allows market making or dealing in derivatives – the exact area addressed by Section 716. A justification for allowing market making under the Volcker Rule was that a properly managed dealer should hedge all of their derivatives dealing risks. However, many of the types of exotic swaps 'pushed out' by Section 716 are the most challenging types of derivatives to risk manage. In fact, one of the major challenges in implementing the Volcker Rule is determining the difference between proprietary trading and market making in the area of customized and exotic swaps. Section 716 will improve protections in this area.

Will 'Pushing Out' Swaps Into a Separate Subsidiary Increase Costs To End Users?

Once the public subsidy to derivatives dealers is removed, the costs of that activity to banks will better reflect its true market risks. Derivatives markets are currently dominated by a few large banks who earn very high profits margins from the activity. Removing the public subsidy will indeed increase costs to the banks. Given the margins earned in this business, there is plenty of room for these costs to be absorbed by dealers themselves. It is also notable that there are many major derivatives dealers that already conduct their swaps activities from separate non-depository subsidiaries, and they are able to compete for business, demonstrating that it is possible to service end users effectively using this model.