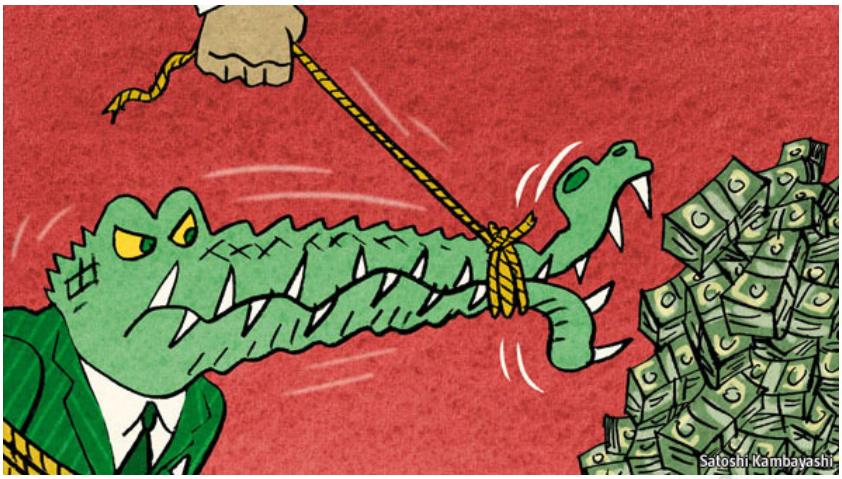
A pox on your swaps

Banks face up to a tougher derivatives regime than many had expected.



FOR all the recent posturing on Capitol Hill, financial reform is coming. On three consecutive days this week Republicans blocked a motion to allow debate of America's financial-regulation bill to begin on the Senate floor, an obstruction that Harry Reid, the chamber's majority leader, denounced as "absurd and stunning". The stand-off finally ended on April 28th, when the opposition party's senators, worried about being branded as bankers' friends, agreed to let discussion proceed.

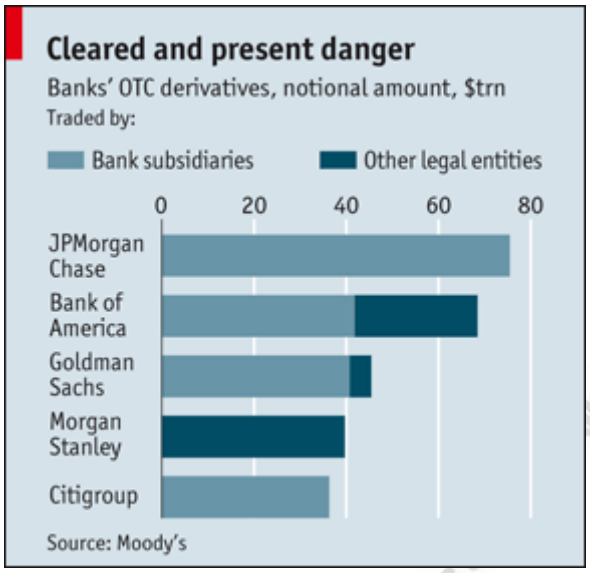
The bill is now very likely to pass in some form, possibly as early as the end of May. But with the two parties' chief negotiators having reached an impasse in bilateral talks, a number of big issues will have to be thrashed out on the floor. One is the treatment of troubled financial giants (although the two sides have got closer on some points). Another is the proposed consumer-protection bureau, which Republicans fear could be a recipe for regulatory overreach. A third is derivatives.

The last of these has been causing particular consternation on Wall Street. Until recently banks thought they knew what was coming: a palatable batch of changes that included standardised over-the-counter (OTC) bilateral contracts being pushed through central clearinghouses (which guarantee trades if one party defaults); exchange trading for more liquid standardised contracts; and higher capital and margin requirements for derivatives that are too customised for clearing.

Something changed in recent weeks, however. The fraud charges filed against Goldman Sachs, over synthetic derivatives, emboldened those looking to crack down on exotic instruments. On April 21st the Senate's Agriculture Committee—which oversees the Commodity Futures Trading Commission (CFTC)—passed a surprisingly draconian set of derivatives provisions. Elements of this will be offered as an amendment to the main bill.

The most controversial bit is Section 106, which would prohibit entities with access to the Fed's discount window—ie, banks—from trading swaps or using them to hedge their own exposures. At the very least, it would force banks to spin off their derivatives desks into non-bank subsidiaries, though some interpret the language to mean an outright ban. Some believe that Section 106 has been left in as a bargaining chip, to be removed in return for a Republican concession. But bankers are edgy. The White House, though queasy about a swaps ban, has not publicly opposed it.

A mere five entities account for more than 95% of American financial firms' derivatives holdings. Of these, Morgan Stanley has the least cause for worry, since its swaps already sit in a non-bank subsidiary (see chart). For the others, moving the business would be costly, because bank-holding companies generally have a higher cost of funding than bank subsidiaries. Estimates of the extra capital required vary from $20 billion to several times that.



This puts a cash cow at risk. Derivatives-dealing has become one of the most profitable activities for Wall Street's giants. The business is thought to have generated revenue of around $22.6 billion in 2009. JPMorgan Chase has said that fully one-third of its investment-banking profits came from OTC derivatives in 2006-2008.

Regulators, too, are nervous. The rules could drive derivatives to offshore markets, over which they have less control. The Fed would not be thrilled at the prospect of having to rely more on non-American banks as dollar intermediaries in the foreign-exchange-swap market. Pushing swaps into new entities may simply create a new class of firms that are too big to fail.

Even if Section 106 is dropped, there are other controversial derivatives-related issues. The bill has been toughened up to require all contracts that can be centrally cleared to be traded on exchanges (partly in response to lobbying from unions, which blame OTC derivatives for falling pension values). To the extent that this exposes in real time the volumes and prices of transactions, it is welcome. Bourses can expect to reap benefits (see article).

But some bankers worry that it could be the equivalent of ramming square pegs into round holes. Mandatory exchange trading is "a solution looking for a problem," says the head of one bankers' association. "End-users"—firms that use derivatives for hedging, such as airlines—are "not exactly clamouring for it," he says.

Many of those end-users, which collectively hold 10-15% of OTC derivatives outstanding, also want exemptions from clearing. Without one, they argue, increased collateral requirements for cleared trades would make hedging their everyday risks much more expensive. As things stand, some commercial firms would get an exemption, while others—such as sweetmakers hedging against swings in sugar prices—would not. Other sorts of carve-out are being sought, too. Warren Buffett's Berkshire Hathaway has lobbied hard, but so far unsuccessfully, against having to post more collateral for existing trades in its $60 billion derivatives book.

Regulators have further worries, too. In a memo circulated this week, the Fed complained that the bill's language is too "hard wired", leaving insufficient room to tweak rules as markets evolve. It also thinks the legislation unnecessarily restricts data-sharing among regulators. But

it is the banks that are most perturbed. They shiver at the possibility of ceding ground to foreign rivals as forced spin-offs raise their costs—or, worse, having to use the likes of Deutsche Bank to hedge their interest-rate risk. Such worries may prove overdone. But a tougher regime than any of them expected a few months ago appears likely.

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