The Swaps Amendment in the Omnibus Appropriations Bill*

Raymond Natter

December, 2014

On December 16, 2014, Congress passed H.R. 83, the Consolidated and Further Continuing Appropriations Act, 2015. This legislation provides funding for the Federal Government for the remainder of this fiscal year. As is typical for massive legislation of this sort, a number of "riders" were added that made substantive changes to the law, rather than simply appropriate funds. One provision in particular, Section 630, has become controversial, with critics arguing that the amendment will be harmful to the safety and soundness of the financial system and will provide FDIC backing for risky swap trades that go bad. Others argue that the amendment will enhance bank safety while lowering costs for "end users," who use swaps to facilitate their business operations, for example, by lowering financing costs or locking in foreign exchange rates. They also note that this provision is truly bi-partisan in nature, with drafting input from both sides of the aisle. This paper will review the history of Section 630, discussing why it was first introduced in 2012, and viewed as noncontroversial until now. We will begin with a brief explanation of what a swap contract does and why it is important for the users of swaps and our economy.

What is a Swap and Why Is It Important?

Basically, a swap is a contract between two parties in which they agree to exchange a flow of funds to facilitate economic activity. For example, a farmer selling wheat to Russia for rubles may want to enter into a foreign exchange swap to make sure that he or she will get the same amount of dollars when the wheat is delivered, even if the value of the ruble declines. Or a company making a variable rate loan may enter into a swap to ensure that it will receive a steady stream of income even as interest rates fluctuate.

Swap agreements serve many important purposes. A company may want to hedge against changes in interest rates, foreign exchange rates, changes in the value of stocks or bonds, or to protect against a credit default. Swaps can be used to hedge risk, or can be used more speculatively, to bet on the direction of market movements. Swaps are important because they reduce the risk of market fluctuations, make it less costly to engage in international trade, lower the cost of financing for end users, and make it possible for businesses to offer more products and services to their customers. On the other hand, swaps also can pose significant risks to counterparties, especially when they are not used strictly to hedge existing positions. For example, when AIG used swaps essentially to bet on the continued rise in housing prices, it suffered huge losses when the housing market declined.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

Dodd-Frank Act Limitations on Bank Swap Activities

During the Senate consideration of the Dodd-Frank Act in 2010, Senator Blanche Lincoln, then Chair of the Senate Agriculture Committee, added a provision that restricted the type of swap activities that can be conducted directly in an insured depository institution. This provision, found at Section 716 of Dodd-Frank, requires depository institutions to "push out" all swap activities to an affiliated company, with certain exceptions. Under Section 716, a bank can engage in swaps to hedge its own risks, and can act as a dealer for swaps that involve interest rates and foreign exchange rates, or with respect to certain assets that are permissible for national banks to own. However, banks are required to "push out" to a separate affiliate other swap activities, including most agriculture-based swaps and equity-based swaps.

The Lincoln amendment was the subject of considerable debate during consideration of Dodd-Frank. Both Federal Reserve Chairman Ben Bernanke and FDIC Chair Sheila Bair opposed the original push-out provision because of possible unintended consequences for our economy. Chairman Bernanke stated in a letter to Senator Dodd that "Section 716 would force derivatives activities out of banks and potentially into less regulated entities or into foreign firms.[1] FDIC Chair Sheila Bair expressed similar concerns in her letter to Senator Dodd, and noted that "One unintended outcome of this [swaps push out] provision would be weakened, not strengthened, protection of the insured bank and the Deposit Insurance Fund."[2]

In light of these concerns, a compromise was reached, and the swaps push-out provision that was adopted as Section 716 contains the exceptions noted above. However, all of the concerns raised in the Bernanke and Bair letters were not addressed, including the fundamental point made by Ms. Bair that moving swap activities from a bank to an affiliate increases the risk to the deposit insurance fund.

2014 Amendment

As amended recently by Section 630 of the Omnibus Appropriations legislation, banks would not be required to push out swaps activities, except for dealing in "structured finance swaps." A structured finance swap is a swap based on asset-backed instruments, such as mortgage-backed bonds. However, the push out does not apply if the swap is for the purpose of hedging or risk management, or if the prudential regulators have jointly adopted a rule permitting a bank to engage in swap transactions relating to the structured finance instrument. Thus, as amended, banks would be able to engage in a broad range of swaps activities, other than those connected to structured products such as mortgage-backed securities.

The change made in section 630 is not new. In 2012, legislation was introduced in the House of Representatives, H.R. 1838, which would have repealed the push-out provision altogether. Ranking member Barney Frank and other minority members objected that complete repeal was too broad, and worked out compromise language that was approved by the committee by voice vote. This language is exactly the same as section 630 in the Omnibus Appropriations Act.

The bi-partisan nature of the 2012 provision is stated clearly in the committee report, where Ranking Member Frank, joined by seventeen other Democratic members of the committee, wrote the following minority views:[3]

> As amended, H.R. 1838 would repeal portions of Section 716 of the financial reform law, also known as the push-out provision." Section 716 prohibits banks from engaging in several types of derivatives. Questions have been raised about this provision by economists and regulators including FDIC's Sheila Bair, who are concerned that it might interfere with a bank's ability to

[1] The entire letter is reproduced ***here***.

[2] The letter is reproduced ***here***

[3] H. Rep. No. 112-476, part 1, 112th Cong. 2nd Sess. (2012) at page 12.

©2014 Barnett Sivon & Natter, P.C.

> use derivatives to diminish risk. Section 716 was not part of the original House-passed version of the financial reform law.
>
> During the Full Committee markup, Democrats worked with the Majority to amend H.R. 1838 to continue the prohibition of complex swaps employed by AIG with devastating effect. H.R. 1838, as amended, addresses the valid criticisms of Section 716 without weakening the financial reform law's important derivative safeguards or prohibitions on bank proprietary trading.

Although this legislation did not pass in 2012, Chairman Bernanke continued to express concerns about the push-out provision. On February 27, 2013, Mr. Bernanke testified before the House Committee on Financial Services that "it's not evident why [Section 716] makes the company as a whole safer. And what we do see is that it will likely increase costs of people who use the derivatives and make it more difficult for the bank to compete with foreign competitors who can provide a more complete set of services."[4]

A week later, Congressman Hultgren, joined by Congressman Himes, re-introduced the same language that was reported by the House Financial Services Committee in 2012, as H.R. 992. It was reported favorably by the House Committee on Financial Services by a vote of 53-6.[5] Dissenting views filed by Maxine Waters and three other Democratic Members focused on the need to complete the rulemaking on the "Volcker amendment" before amending the swaps provision. The regulatory implementation of the Volcker amendment includes prohibitions on proprietary trading by banks and clarifies the distinction between hedging and other investment activities.

During the debate on the House floor, Ms. Waters argued that the amendment would also make it easier for a bank to hide manipulation from regulators. She noted allegations of energy market manipulation and possible manipulation in the aluminum markets. Ms. Waters also cited the losses caused by the "London Whale" incident. The London Whale incident also apparently changed the view of Sheila Bair. Representative Waters quoted Sheila Bair as saying that:

> "Derivatives have many legitimate functions, but they can be high risk and poorly understood because of their complexity by bank managers and even regulators, as we saw with the "London Whale" debacle. So keeping them outside of insured banks and making the market fund them is the way to go. This will increase market discipline and protect the FDIC.. . . I'm concerned that Members of Congress act on these issues without full understanding of the ramifications. If we are going to revisit derivatives regulation, I'd go in the direction of more market discipline and disclosure, rather than letting big derivatives dealers use insured deposits to support their high-risk operations."[6]

However, neither Representative Waters nor Sheila Bair addressed the point made by Federal Reserve Chairman Ben Bernanke, when he testified in 2013 that the swaps push-out does not make the banking company as a whole safer, but instead will likely increase costs to individuals and businesses who use the derivatives and make it more difficult for the bank to compete with foreign competitors, who can provide a more complete set of services without similar restrictions.[7]

This legislation passed the House of Representatives by a vote of 292-122 on October 30, 2013. The same language in this bill was adopted without change as Section 630 of the Omnibus Appropriations Act on December 16, 2014.

---

[4] See ***here***.

[5] H. Rep. No. 113-229, part 1, (113th Cong. 1th Sess. (2013).

[6] Congressional Record at H6920 (2013).

[7] ***Hearings held by the House Committee on Financial Services*** (February 27, 2013).

©2014 Barnett Sivon & Natter, P.C.

Conclusion

The swaps push-out provision that was adopted as Section 716 of the Dodd-Frank Act was controversial from the very start. Supporters believed that it was a critically important safety and soundness enhancement, designed to prevent the type of losses suffered by AIG. Some of the leading regulatory agencies, such as the Federal Reserve Board and the FDIC, as well as economists, other experts, and end users questioned the wisdom of the provision, and expressed concerns that it would actually make it more costly for swaps users and more difficult for regulators to monitor swap activity.

Beginning in 2012, bi-partisan legislation was introduced to modify the swaps push-out provision. The version of the bill that was reported by the House Financial Services Committee in that year reflected the input of the Democratic members of the committee, and was passed without dissent. However, in 2013, opposition to the provision was expressed by a few Democratic Members. Nevertheless, the bill was still supported by an overwhelming bipartisan majority in the House of Representatives. In 2014, the exact language was added to the Omnibus Appropriations measure as Section 630.

The current discussion concerning this amendment appears to overlook the policy considerations that went into the development of this proposal, the bi-partisan nature of the legislation, and the need to balance the arguments both for and against passage.

Raymond Natter is a partner with the law firm of ***Barnett Sivon & Natter, P.C.***

©2014 Barnett Sivon & Natter, P.C.