

Nothing But The Facts: The Swaps Pushout Rule

Section 716 of the Dodd-Frank Act (the “swaps pushout rule”) prohibited the extension of “federal assistance” to an insured depository institution (“IDI”) that trades certain covered swaps (derivatives not traded on exchanges, so-called OTC derivatives). “Federal assistance” includes most FDIC guarantees, and Federal Reserve credit facility/discount window lending. However, as enacted by Dodd-Frank, the scope of the swaps pushout rule was always limited since it exempted interest rate, foreign exchange, precious metal, and cleared credit default swaps (“CDSs”). Exchange-traded derivatives like futures and options were also never covered by the swaps pushout rule. Under Dodd-Frank, the swaps pushout rule primarily affected uncleared CDSs, equity swaps, and non-precious-metal-commodity swaps (“commodity swaps”).

A legislative amendment signed into law with the Consolidated and Further Continuing Appropriations Act in December 2014 further excluded uncleared CDSs, equity swaps, and non-precious-metal commodity swaps (the “amendment”) from the swaps pushout rule. Although the Committee on Capital Markets Regulation is not taking a position on the amendment, some lawmakers have suggested that it has undermined key aspects of Dodd-Frank’s reforms of the swaps markets.

Senator Elizabeth Warren (D-MA) has stated that the amendment will exclude approximately \$14 trillion of gross notional swaps activity from the swaps pushout rule.¹ Because IDI’s hold approximately \$225 trillion of gross notional derivatives that were already excluded from the swaps pushout rule, this means that the amendment increases the excluded activity by 6.2% of gross notional. However, gross notional is an inaccurate measure for assessing the risk magnitude of swaps activity, as it does not reflect the market risk of a swap or credit risk from a counterparty default. There are far better measures readily available for determining the risk magnitude of swaps than gross notional.

For example, the market risk to an IDI that has sold or bought CDS protection depends on the likelihood that the reference entity will go bankrupt. That risk is reflected in the market value of the CDS, but not the notional amount. Therefore, using the notional amount to measure risk suggests that risk of selling CDS protection on \$100 million of U.S. treasuries is the same as selling protection on \$100 million of Greek government debt. Obviously, this is untrue.

Prudential regulators, including the Office of the Comptroller of the Currency (the “OCC”), collect aggregate IDI data that is related to the market and credit risk of swaps. So does the Basel Committee on Banking Supervision (“Basel Committee”), which is the international body of bank regulators that determines the capital framework that forms the basis for the minimum capital requirements applicable to IDIs. This data generally pertains to *derivative* exposures, which includes futures and options, as well as swaps.

More specifically, the OCC, Basel Committee, and other prudential regulators collect aggregate data regarding the gross market value (“GMV”) of all derivatives held by IDIs. The GMV is the cost of replacing all derivatives at market prices,² fluctuating due to market risk, among other factors. These regulators also collect data related to the potential future exposure (“PFE”) of derivatives held by IDIs. Potential future exposure (“PFE”) relates to the future volatility of the market risk of a swap and measures the commensurate credit exposure to the IDI. Finally, regulators also collect data regarding the net current

¹ <http://www.warren.senate.gov/files/documents/BankofAmericaLetter.pdf>

² http://www.bis.org/publ/otc_hy1411.pdf at 2. Gross market value is computed as the sum of gross positive fair market values and the absolute value of gross negative fair market value, as disclosed on page 4 of the Q3 2014 OCC Derivatives Report: <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq314.pdf>

credit exposure (“NCCE”) for all IDIs’ derivatives positions. NCCE is a measure of IDIs’ aggregate credit exposure to *all* counterparty defaults and is the OCC’s “primary metric used to evaluate credit risk in bank derivatives activities.”³ Although GMV, PFE, and NCCE do not include all potential future market or credit risk from these derivative activities, they are far more accurate measures of risk magnitude than gross notional.

With regards to GMV, equity and commodity derivatives make up around 4%, or \$277 billion, of total derivatives GMV on IDI balance sheets. Credit derivatives comprise 4.85%, or \$334 billion, of derivatives GMV on IDI balance sheets. Thus, equity, commodity, and credit derivatives have a total GMV of \$561 billion. However, this amount is over inclusive as it includes cleared and uncleared CDSs. Only uncleared CDSs were affected by the Amendment. Although IDIs do not publicly disclose data on the percentage of outstanding credit derivatives that are cleared, the Dodd-Frank clearing requirements have generally increased the fraction of new credit derivatives that *are* cleared from 0% in 2009 to almost 80% in 2014.⁴ However, we note that the least liquid CDSs will remain uncleared and that uncleared CDSs generally pose greater risk to IDIs than highly liquid, cleared CDSs.

Another measure of risk, PFE, is computed by multiplying the notional amount of a swap by a conversion factor that depends on the underlying asset type and the remaining maturity. These conversion factors are determined by the Basel Committee’s standardized approach, which applies pre-determined multipliers that are roughly related to the future risk and volatility of each type of swap. Higher conversion factors apply to swaps with a higher potential for future volatility. For example, the standardized approach would apply a multiplier of 0.1 to the notional of any CDS on a non-investment grade asset, regardless of maturity. This is clearly a crude approach, as the future risk of a CDS is related to its maturity.

Based on the Basel Committee’s conversion factors, the total IDI PFE is \$79.2 billion for equity swaps, \$56.3 billion for commodity swaps, and \$664.5 billion for CDSs. Thus, equity, commodity, and credit derivatives have a total PFE of \$800 billion, which is 45% of the total \$1.76 trillion of PFE held by IDIs. We again note that this amount for CDSs is over inclusive, as it includes cleared and uncleared CDSs. However, just like GMV, the PFE for an uncleared CDS is higher than the PFE for a cleared CDS, as uncleared CDSs have a higher potential for future volatility than cleared CDSs. For example, pursuant to the CFTC’s approach to calculating PFE (which does not apply to IDIs) the PFE of an uncleared CDS is generally double the PFE for a cleared CDS.

It is important to note that, according to the OCC, “[IDIs] hedge the market risk of their derivatives portfolios” and therefore IDIs generally maintain an equal number of derivatives with a positive market value as a negative market value.⁵ This is consistent with the Volcker Rule, which limits IDI derivatives activity to market making and hedging. This is best explained with an example. If an IDI has *bought* CDS protection on a reference entity and the likelihood that the entity will default increases, then the positive market value of that CDS also increases. The opposite is true if the IDI had *sold* CDS protection on that reference entity. Therefore, buying and selling similar amounts of the same type of CDS reduces market risk exposure. The OCC collects data on the aggregate positive and negative market values of IDIs’ equity, commodity, and credit derivatives. The net market value for equity, commodity, and credit derivatives held by IDIs is -\$1 billion, \$0, and +\$4 billion, respectively.⁶

However, even if IDIs were able to completely hedge their market risk, they could still be exposed to credit risk if a derivative counterparty defaults. Net current credit exposure (“NCCE”), is the

³ Id at 4.

⁴ <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf> at 89 Figure 5.6.3

⁵ Q3 2014 OCC Derivatives Report at 4.

⁶ <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq314.pdf> at 5.

OCC's primary metric for measuring the credit risk to IDIs from a *counterparty* default.⁷ If an IDI has a legally enforceable netting agreement in place with a counterparty, then the NCCE approach allows an IDI to offset their derivatives with a positive market value against their derivatives with a negative market value with that counterparty. This type of netting takes place across different types of derivatives, so long as they are between the same counterparties. Netting agreements are only one of several ways that IDIs can manage counterparty risk. Alternative methods to manage credit risk to a specific counterparty include holding a CDS on that counterparty as protection against the default of that counterparty or entering into offsetting derivatives with a *different* counterparty. In the event of a counterparty default, all three methods of managing counterparty risk are subject to some uncertainty and may not produce as clean of an outcome as intended.

The aggregate NCCE for IDIs *total* derivative activities is \$398 billion.⁸ Importantly, NCCE does not consider collateral posted in derivatives transactions. Because collateral can be seized in the event of a counterparty default, it further reduces counterparty credit risk. According to the OCC, IDIs hold collateral against 80% of NCCE, so uncollateralized IDI exposure to credit risk is \$79.6 billion.

In conclusion, while GMV, NCCE, and PFE are not complete estimates of the market or credit risk of equity, commodity, or credit swaps, it is clear that they are far better measures of risk magnitude than gross notional. Therefore, there are certainly a number of alternative ways to think about the risk affected from the Amendment aside from Senator Warren's statement that, "the covered swaps transactions have an estimated value of up to \$14 trillion."

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Founded in 2006, the Committee on Capital Markets Regulation is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

⁷ "NCCE is the primary metric assessing credit risk by the OCC."

⁸ <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq314.pdf>