GAO Highlights

Highlights of GAO-17-607, a report to congressional requesters

September 2017

FINANCIAL REGULATION

Perspectives on the Swaps Push-Out Rule

Why GAO Did This Study

Given the role of derivatives in contributing to the 2007—2009 financial crisis, the Dodd-Frank Act includes various provisions that subject the swap market and its participants to greater regulation, including section 716. Proponents of section 716 sought to prohibit banks from engaging in riskier swap activities that could cause the banks to need federal assistance backed by taxpayers. Opponents of section 716 maintained that swaps trading by banks did not significantly contribute to the financial crisis. In late 2014, section 716 was amended to narrow its scope of prohibited swap activities. Banks generally were required to begin complying with the amended section 716 in July 2015.

GAO was asked to examine various effects of the amended and original versions of section 716. This report examines the provision's effect on U.S. banks and their BHCs, end-users of swaps, and taxpayers in light of other Dodd-Frank Act reforms.

GAO analyzed publicly available data on swaps and derivatives held by banks and their BHCs and reviewed laws and regulations applicable to swaps as well as academic, industry, and GAO reports, research, and other materials. GAO also interviewed federal banking and swaps regulators, 15 U.S. banks that were registered as swap dealers and thus covered by section 716, end-users that were or would have been affected by section 716, an industry association, and experts, such as academics researching the swaps market.

View GAO-17-607. For more information, contact Lawrance L. Evans, Jr., at (202) 512-8678 or EvansL@gao.gov

What GAO Found

Since the 1980s, banks have been engaging in swaps: financial contracts (derivatives) in which two parties "swap," or exchange, payments based on changes in asset prices or other values. A variety of firms (end-users) use swaps to hedge risk, to speculate, or for other purposes. For example, an airline may use swaps to lock in its fuel price to hedge against a future price rise. End-users engage in swaps through swap dealers, and some large banks act as swap dealers, exposing them to risks. Section 716 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)—also known as the "swaps push-out rule"—requires banks registered as swap dealers, in effect, to stop engaging in certain swap activities to remain eligible for federal financial assistance but allows them to "push out" such activities to nonbank affiliates within the same bank holding company (BHC). As originally enacted, section 716 would have covered certain equity, commodity, and credit default swaps activities, but amendments made in 2014 now cover only certain swap activity based on asset-backed securities.

GAO analyses of the effects of the amended and original versions of section 716 on U.S. banks and their BHCs, swap end-users, and taxpayers in light of other Dodd-Frank Act reforms found the following:

- *A significantly larger volume of swaps would have been pushed out under the original section 716*. The amended section 716 affected four U.S. banks and caused them to push out an estimated $265 billion of swaps in notional value as of September 30, 2016, or less than 1 percent of their total derivatives. The original version would have affected 11 U.S. banks (including the 4 banks) and could have affected an estimated $10.5 trillion of swaps in notional value, or about 6 percent of their total derivatives, if the provision had not been amended.
- *Section 716 increases risks and costs for BHCs and end-users*. Under the amended version, banks moved their covered swap activities to nonbank affiliates, requiring the affiliates and clients to incur legal and operational costs. Banks and end-users told GAO that moving the swaps can increase their risks and, in turn, costs. Such risks and costs likely would have been greater under the original version because of its broader scope.
- *Other Dodd-Frank Act provisions mitigate risks*. Section 716 seeks to reduce a bank's risk of failure and potential need for federal assistance, but the act's other reforms also seek to mitigate such risks. For example, regulators have subjected banks to enhanced prudential and other requirements that can help to mitigate their swap-related risks. Consistent with such requirements, GAO's analyses indicate the 11 U.S. banks that would have been affected by the original section 716 held financial resources needed to support their swap-related credit, liquidity, and market risk exposures as of September 30, 2016. Federal banking regulators and BHCs with the largest bank swap dealers are continuing to develop resolution strategies that seek to resolve a large BHC in an orderly manner and without federal assistance if it were to fail. These strategies, if successful, can help BHCs to wind-down or sell their swaps in an orderly manner and avoid value destruction.