SWAPPING REGULATIONS FOR OFFSHORE RISK

HOW THE U.S. BANKS SIDESTEPPED DODD FRANK & PUT THE WORLD ECONOMY AT RISK ONCE AGAIN

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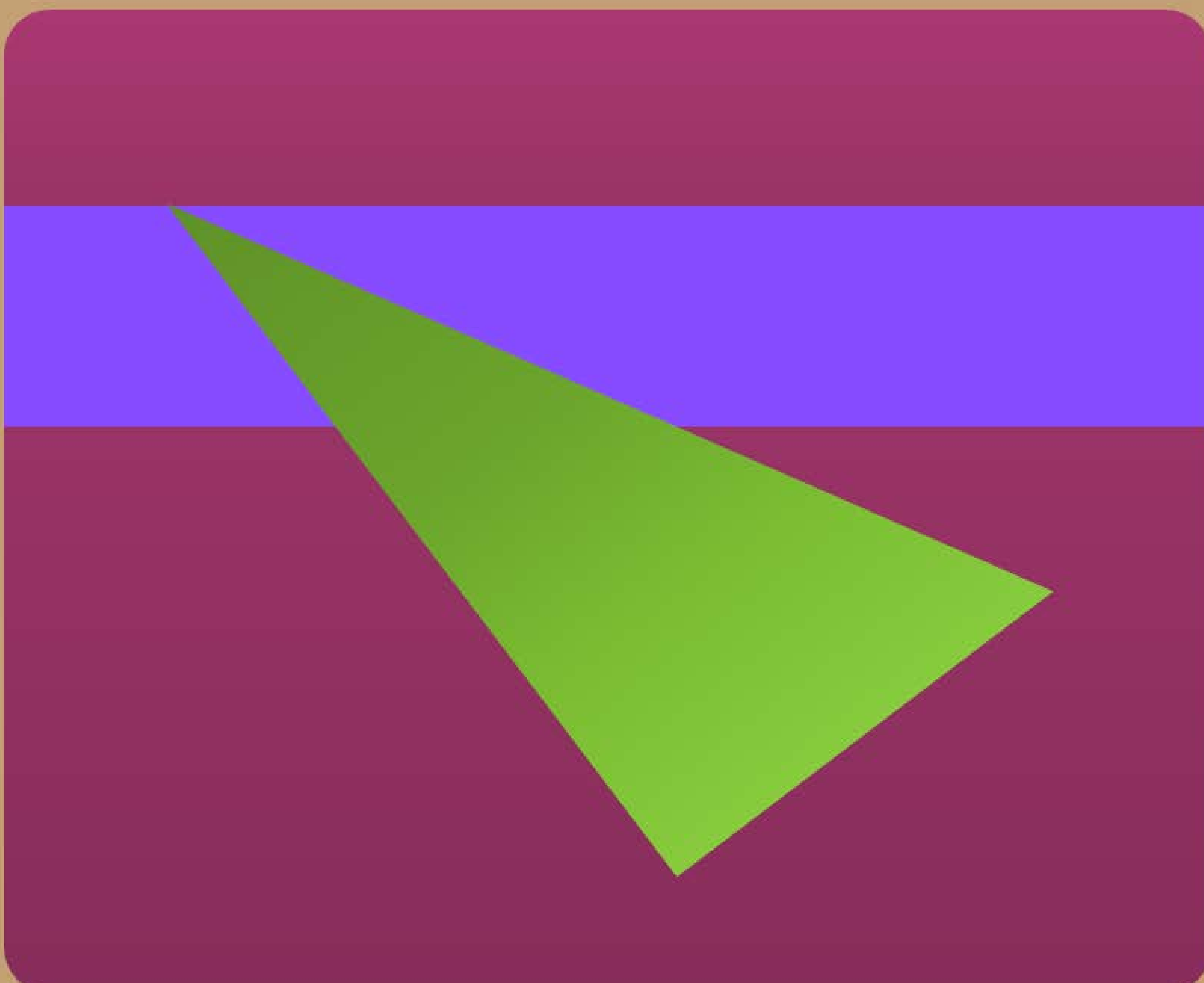

Swapping regulations for offshore risk: the full story of how U.S. banks sidestepped Dodd Frank and put the world economy at risk once again

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Prof. Greenberger describes in his 2018 paper how Dodd Frank regulations were put in place to protect the global economy from dangerous Swaps trading after 2008 but these rules were sidestepped by U.S banks using an offshore loophole.

The full article can be downloaded for free here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228783

In this post I will expand on some of the ideas in my post from yesterday and highlight some of the key facts about Swaps regulation avoidance as described in Prof. Greenberger's paper.

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Too Big to Fail U.S. Banks' Regulatory Alchemy: Converting an Obscure Agency Footnote into an "At Will" Nullification of Dodd-Frank's Regulation of the Multi-Trillion Dollar Financial Swaps Market

Michael Greenberger[1]

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ABSTRACT

The multi-trillion dollar market for, what was at that time wholly unregulated, over-the-counter derivatives ("swaps") is widely viewed as a principal cause of the 2008 worldwide financial meltdown. The Dodd-Frank Act, signed into law on July 21, 2010, was expressly considered by Congress as a remedy for the deregulatory problems, in that market, that led to the crash. The legislation required the swaps market, subject to U.S. regulation, to comply with a host of business conduct and anti-competitive protections, including that the swaps market be fully transparent to U.S. financial regulators, collateralized, and capitalized. The statute also expressly provides that it would cover foreign subsidiaries of big U.S. financial institutions if their swaps trading could adversely impact the U.S. economy or represent an attempt to "evade" Dodd-Frank.

This is an overview of the key ideas of the paper.

In July 2013, the CFTC promulgated an 80 page, triple columned, and single-spaced "guidance" implementing Dodd-Frank's extraterritorial reach, *i.e.,* that manner in which Dodd-Frank would apply to swaps transactions executed outside the United States. The key point of that guidance was that "guaranteed" foreign subsidiaries of U.S. bank holding company swaps dealers were subject to all of Dodd-Frank's swaps regulations wherever in the world those subsidiaries' swaps were executed. At that time, the standardized industry swaps agreement contemplated that*, inter alia,* U.S. swaps dealers foreign subsidiaries would be "guaranteed" by their corporate parent, as was true since 1992.

In August 2013, without notifying the CFTC, the principal swaps dealer trade association privately circulated to its member's standard contractual language that would, for the first time, "deguarantee" foreign subsidiaries. By relying only on the obscure footnote 563 of the CFTC guidance's 662 footnotes, the trade association assured its swaps dealer members that the newly deguaranteed foreign subsidiaries could (if they so choose) no longer be subject to Dodd-Frank.

As a result, it has been reported (and also has been understood by many experts within the swaps industry) that a substantial portion of the U.S. swaps market has shifted from the large U.S. bank holding companies swaps dealers and their U.S. affiliates to their newly deguaranteed "foreign" subsidiaries. The CFTC also soon discovered that these huge U.S. bank holding company swaps dealers, through their foreign subsidiaries, were "arranging, negotiating, and executing" these swaps *in the United States with U.S. bank personnel* and, only *after* execution in the U.S., were these swaps formally "assigned" to the U.S. banks' newly "deguaranteed" foreign subsidiaries with the accompanying claim that these swaps, even though executed in the U.S., were not covered by Dodd-Frank.

Regulatory guidance was put in place in 2013 by the Commodity Futures Trading Commission (CFTC) to clarify that ***all Swaps transactions by foreign subsidiaries should fall under the regulatory framework set out by Dodd-Frank***. This includes increased transparency, as well as clearly defined capital and collateral requirements.

In a key part of the guidance, under a buried 563rd footnote, it was stated that "guaranteed" foreign subsidiaries should fall under the Dodd-Frank regulations. The term ***"guaranteed" foreign subsidiaries*** was not considered problematic in any way as all U.S. swaps dealers' foreign subsidiaries had been guaranteed by their corporate parents since 1992. ***This piece of wording was all that was required to create a monumental loophole***.

In complete surprise to the CFTC ***the swaps dealer trade association privately circulated the suggestion that if it's members "deguaranteed" their foreign subsidiaries then these foreign subsidiaries would be exempt from Dodd-Frank regulation***. Loophole established.

In the coming months and years there was a substantial shift in the U.S. swaps trading from large U.S. bank holding companies swaps dealers to newly deguaranteed "foreign" subsidiaries. ***And with that, regulations were out the window and the pre-2008 swaps game was back on at the casino***.

In October 2016, the CFTC proposed a rule that would have closed these loopholes completely. However, the proposed rule was not finalized prior to the inauguration of President Trump. All indications are that it will never be finalized during a Trump Administration.

Thus, as the tenth anniversary of the Lehman failure approaches, there is an understanding among many market regulators and swaps trading experts that large portions of the swaps market have moved from U.S. bank holding company swaps dealers to their newly deguaranteed foreign affiliates. However, what has not moved abroad is the very real obligation of the lender of last resort to rescue these U.S. swaps dealer bank holding companies if they fail because of poorly regulated swaps in their deguaranteed foreign subsidiaries, *i.e.*, the U.S. taxpayer.

While relief is unlikely to be forthcoming from either the Trump Administration or a Republican-controlled Congress, some other means will have to be found to avert another multi-trillion dollar bank bailout and/or financial calamity caused by poorly regulated swaps on the books of big U.S. banks. This paper notes that the relevant statutory framework affords state attorneys general and state financial regulators the right to bring so-called "*parens patriae*" actions in federal district court to enforce, *inter alia*, Dodd-Frank on behalf of a state's citizens. That kind of litigation to enforce the statute's extraterritorial provisions is now badly needed.

The CFTC never intended this loophole to be exploited and penned an amendment that would've closed the loopholes completely. However before the new rule was finalised the U.S. administration changed. ***The new administration seemed to have no interest in implementing the pending rule***.

Despite all the swaps being moved offshore and out of the sight of regulators, ***the liabilities from dangerous offshore swaps bets remain on the books of U.S. banks and, if large enough, will once again fall upon the shoulders of the U.S. tax payers***.

Litigation is possible and necessary to end this corrupt swaps loophole. ***A rule is ready to end the game and we have a new administration since January***. Let's put pressure on the CFTC and the SEC to enforce the Dodd-Frank protections.

Footnote:

Good ol' GG Gary Gensler was the head of the CFTC as the Dodd-Frank rules were being more heavily enforced in 2013. His team got blindsided by the swaps dealer trade association creating the new loophole. Before the loophole could be fixed a new administration came in and the discussion was over.

GG clearly knows what's been going on here. I suspect that's why he was picked for the job. Let's let him know that we know whats up with Dodd-Frank swaps dodging. Let's let the CFTC know that we know and demand for their proposed rule to be put in place immediately (if it hasn't already! So many new rules this year). Once again the big banks are the bad guys. This time they should fail and their executives should end up in jail.

Final note: all this info comes from the brilliant mind of Prof. Greenberger. Let's get him on for another AMA!!! Once again his full article can be found here: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3228783