



Nonprofit Publisher  
of Consumer Reports

**Re: Letter of support for the Prohibition against Federal Government Bailouts of Swaps Entities**

May 12, 2010

Dear Senator:

As the Senate continues to debate financial reform, Consumers Union<sup>®</sup>, the nonprofit publisher of *Consumer Reports*<sup>®</sup>, strongly urge you to support Section 716 (“Prohibition Against Federal Government Bailouts of Swaps Entities”) as part of the Dodd-Lincoln substitute to the Restoring Financial Stability Act of 2010. It, along with other structural reforms under consideration such as a statutory Volcker Rule and limits on bank size and leverage (the Merkley-Levin and Brown-Kaufman amendments), will sharply reduce the possibility of taxpayer bailouts for speculative activity that does not serve the real economy.

It is now almost universally recognized that the fuse that lit the worldwide economic meltdown in the fall of 2008 was the \$600 trillion, severely under-capitalized and unregulated and opaque swaps market, dominated by the world’s largest banks. Section 716 is designed to ensure that the American taxpayer is not the banker of last resort, as was true in the bank bailouts in 2008-2009, for casino-like investments marketed by large Wall Street swap dealer-banks. Section 716 is a flat ban on federal government assistance to “any swap entity,” especially in instances where that entity cannot fulfill obligations emanating from highly risky swaps transactions. Specifically, Section 716 bars “advances from any Federal Reserve credit facility, discount window...or [loan or debt guarantees by the] Federal Deposit Insurance Corporation.”

Section 716 will require, *inter alia*, the five largest swaps dealer banks to sever their swaps desks from the bank holding corporate structure. Those five banks are: Goldman Sachs, Morgan Stanley, J.P. Morgan Chase, Citigroup, and Bank of America, the institutions involved in well over 90 per cent of swaps transactions. Under Section 716 a “swap entity” and a banking entity could not be contained within the same bank holding company, if the bank holding company has access to federal assistance.

By quarantining highly risky swaps trading from banking altogether, federally insured deposits will not be put at risk by toxic swaps transactions. Moreover, banks will be forced to behave like banks, focusing on extending credit in a manner that builds economic strength as opposed to fostering worldwide economic instability. Finally, the spun off swaps entity will

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be sufficiently isolated to permit the kind of careful prudential oversight mandated by Title VII of the Act as a whole. Title VII ensures that the spun-off entities will both be regulated as institutions under the most rigorous prudential standards, and that almost all of the swaps instruments will be subject to standards for capital adequacy, full transparency, anti-fraud and anti-manipulation.

We understand that the largest banks which are the major dealers and their allies are arguing that taking swaps trading out of the banks will raise the price of hedging for customers and reduce market liquidity. They are wrong. Purely speculative financial derivatives now represent \$78 for every \$1 in true hedging by businesses and farmers. Regulation that reduces de-stabilizing speculative hedging will actually benefit legitimate commercial the “cost argument” promulgated by the “Too Big to Fail” banks begs the question: why does attaching derivatives desks to our large banks result in cheaper derivatives products? The co-mingling of derivatives desks and other banking activities produces the formerly implicit, and now all-too-explicit, guarantee of the federal taxpayer. In the current high-risk environment, availability and pricing for hundreds of trillions of dollars in swaps can be maintained only if counterparties are assured that the Fed’s backup liquidity will continue. On their own, these banks cannot create the liquidity that a market with such high levels of risk would require to sustain a disruption. That is why the banks must not be allowed to continue to deal in risky transactions that threaten deposits, the taxpayer backstop, and banks’ core lending function.

Opponents of Sec. 716 also argue that it will force swaps activity into non-regulated entities or into the overseas market. The Europeans’ experience with credit default swaps on Greece’s government debt suggests that no central bank going forward will want to face this level of risk to its banking systems. There is every indication that the G-20 countries and many other sovereigns are prepared to constrain reckless and abusive swaps activity. The idea that systemically risky swaps-trading will migrate abroad is belied by the hostility to such trading by, for example, the European Commission and other G-20 countries. In the wake of the havoc on the Euro wrought by currency and credit default swaps, the European Commission is not eager to leave these instruments unregulated.

Section 716 is critical to ending our “too interconnected to fail” economy. We ask that you support the bill, and oppose any attempts to weaken Section 716 or to widen any loopholes in the derivatives title of the bill.

Please contact Lisa Lindsley, Director, Capital Strategies, AFSCME, for more information: 202.429.1275 or [llindsley@afscme.org](mailto:llindsley@afscme.org).

Sincerely,



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