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Key points from Congress's roll-back of the Swaps Push-Out

Over the weekend, the US Senate passed an appropriations bill for the President's signature that included a provision to roll back much of Dodd-Frank's section 716 (i.e., the Swaps Push-Out). The initial version of the Swaps Push-Out was proposed by Senator Blanche Lincoln (Democrat of Arkansas) in 2010, during her re-election campaign, and would have prohibited bank swap dealers from receiving federal assistance from the FDIC or from the discount window of the Federal Reserve. After intense negotiation in the last days of congressional debate on Dodd-Frank, Lincoln's version was substantially narrowed to only prohibit banks from dealing in swaps that were viewed by Congress as the most risky.

The Swaps Push-Out that ultimately passed as part of Dodd-Frank prohibited bank swap dealers (with access to FDIC insurance or the discount window) from dealing in certain swaps (or security-based swaps), including most credit default swaps (CDS), equity swaps, and many commodity swaps. Swaps related to rates, currencies, or underlying assets that national banks may hold (e.g., loans) were allowed to remain in the bank, as were swaps used for hedging or similar risk mitigation activities.

Congress's roll-back further narrows the scope of swaps that must be pushed out of the bank to now include only "structured finance swaps," which are defined as swaps referencing asset backed securities (ABS) (or a group or index primarily comprised of ABS).[1] Furthermore, these swaps need not be pushed out if they are used for hedging or risk mitigation, or if their underlying ABS is of a sufficient credit quality (or type or category) deemed permissible by prudential regulators.

1. **Rolling back the Push-Out reduces industry costs and risk management complexity, but does not greatly impact the swaps market:** Moving swaps from the bank dealer to a nonbank affiliate within the bank holding company (BHC) under Dodd-Frank's Push-Out would have meant somewhat higher capital and risk management costs allocated to the nonbank affiliate, resulting in reduced profitability and potential risk management challenges for BHCs (e.g., increased incidence of split hedges among affiliates). Furthermore, many BHCs would have had to implement significant systems changes and likely renegotiate contracts with clients to move swaps to the nonbank affiliate. However, the overall swaps market would not have been greatly impacted under Dodd-Frank's Push-Out: swaps that were required to be pushed-out made up only a small percentage of the overall market, and BHCs would still have been allowed to conduct pushed-out swaps activities in subsidiaries outside of their insured banks. Therefore, the roll-back simply reduces capital and risk management costs for market-makers, while allowing those with smaller market presence that may have ceased market-making in pushed-out swaps to continue to participate as dealers.

2. **Congress's change to the Push-Out is not surprising:** Senator Lincoln's amendment underwent intense negotiation in the last days of debate over Dodd-Frank and was the last major controversy to be resolved. Since then many Republicans and Democrats, as well as some regulators, have continued to voice disagreement with the Push-Out. A bill to roll it back passed the House on a fairly bipartisan basis, and the Federal Reserve and OCC extended the Push-Out compliance deadline by two years to July 16, 2015. Some banking regulators have also expressed concern that moving these swaps out of insured banks to CFTC- and SEC-registered dealers would have impeded their prudential supervision. For these reasons, we asserted in a brief soon after the November elections that this section of Dodd-Frank was the most likely provision of importance to large firms to be changed.[2]

3. **Other Dodd-Frank provisions limiting swaps risk-taking remain intact:** Although insured banks may now continue to engage in a broader array of swaps-related activities, they and all of their affiliates are still prohibited by the Volcker Rule from engaging in the proprietary trading of swaps.[3] They also remain subject to rules that when finalized in the US, likely next year, will require initial margin for uncleared swaps.[4] We do not believe that roll-back of the Push-Out foreshadows any changes to these provisions of Dodd-Frank, which are in our view more fundamental aspects of derivatives reform than was the Push-Out.

4. **The Push-Out deadline will likely remain July 16, 2015:** Given Congress's narrowing of the Push-Out, we do not believe the regulators will be inclined to extend the deadline again. In particular, the OCC's Thomas Curry (who must approve any extensions for national banks) has expressed skepticism that another extension is warranted.

5. **BHCs still have work to do:** BHCs should evaluate several items as they consider moving their structured finance swap business to an uninsured entity, or ceasing these operations, including:
   - Identify swaps referencing ABS on their insured banks' balance sheets, and review the scope of affected clients and impacted revenue.
   - Consider necessary systems and operations changes/updates for moving the structured finance swap business, including those at the insured bank (e.g., adjusting booking models) as well as those at the receiving entity (e.g., updating trading systems and collateral management).
   - Assess the adequacy of capital at the receiving entity and review whether any additional regulatory requirements will apply by taking on structured finance swaps.
   - Consider the length of time and effort required to renegotiate terms with various clients of the structured finance swap business, recognizing that some may be less willing than others to accept more costly terms with the new entity.

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[1] Congress's action also codifies a Federal Reserve regulation that was issued in 2013 in order to level the playing field between uninsured branches (and agencies) of foreign banks and insured US banks. The regulation had the practical effect of allowing foreign firms to benefit, like US banks, from the Push-Out's transition period, grandfathering period, and exemptions. See PwC's *Regulatory Brief, Swaps Push-out: FBOs get needed relief* (June 2013).

[2] See PwC's *First take: The new Republican Senate* (November 10, 2014). We also anticipated that another Dodd-Frank provision would be changed by Congress, i.e., the Collins Amendment which imposes a capital floor on firms deemed systemically important. Congress partially rolled back this provision's application to insurance companies a couple days before the Push-Out revision.

[3] See PwC's *A closer look, Volcker rule clarity: Waiting for Godot* (May 2014).

[4] See PwC's *First take: Uncleared margin re-proposal* (September 5, 2014).

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