Banks will keep lucrative business

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This summer - on July 21 - U.S. President Barack Obama signed into law the highly anticipated U.S. financial regulatory reform bill. Proposed more than a year ago, on June 17, 2009, this financial bill was introduced – in Obama's words - as a "sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression". With such a challenging aim it was bound to cause heated discussions among lawmakers. You could have bet that its way through the U.S. Congress wouldn't be an easy one – and it wasn't. The House of Representatives cleared the bill - named as Wall Street Reform and Consumer Protection Act of 2009 - very quickly (only 9 days passed from its introduction to its approval by the House on December 11 last year). But the Senate, which introduced its own version of the bill called Restoring American Financial Stability Act of 2010, turned out to be more sensitive to the financial lobbying and the bill stayed in the upper house of the Congress for several months. It would have probably still been there if not for the decisive actions of President Obama. On April 22 he gathered some 700 top representatives of the financial and business circles in the Great Hall of Cooper Union, a historic place next to Wall Street where in 1860 Abraham Lincoln made a stirring appeal for saving the Union. Obama's speech at Cooper Union was no less memorable. "I believe in the power of the free market," said Obama. "But a free market was never meant to be a free license to take whatever you can get, however you can get it." Giving a meaningful look to the audience President Obama continued: "I am here today because I want to urge you to join us, instead of fighting us in this effort." President – with all the intensity and force he could express – called on the audience to support the proposed financial reforms and to stop "the furious efforts of industry lobbyists to shape them to their special interests."

Mr Obama is truly a remarkable speaker, but - with billions of dollars at stake for the financial industry – President's words alone wouldn't have been enough to change the dead-end situation. However his speech came right after some shocking and unprecedented developments in the U.S. banking sector, which had drastically weakened the position of the financial lobby. A few days before the Obama's speech - on April 16 – the biggest U.S. bank Goldman Sachs was charged with fraud by the U.S. Securities and Exchange Commission. The civil lawsuit, filed by SEC, was based on a deal made in 2007, in which Goldman Sachs failed to disclose to its investors a conflict of interest on mortgage investments it sold. The story that was uncovered looked really ugly for Goldman, which had already been under public criticism over its high compensation and its preferential treatment. It is worth to recall what the case was about. At its core was a synthetic collateralized debt obligation, or CDO, called "ABACUS 2007-AC1". Stephen Gandel from TIME Magazine gave a great explanation of the whole deal. In his article "The case against Goldman Sachs" he wrote: "On the surface, these deals look complicated. They are. But the alleged fraud at the heart of the case against Goldman and its CDO dealings is one of the simplest and oldest forms of deception: lying. According to the SEC, Goldman told one group of investors they were buying a AAA-rated high-yield investment put together by an independent firm called ACA Management. But the SEC says the person really picking the collateral was Paulson, an investor whose only interest was: Paulson. What Goldman allegedly sold, like any good snake-oil salesman, was a worthless, well-packaged fake."

We know by now that three months later this unprecedented lawsuit will be settled rather amicably: Goldman will pay a fine of $550 million, which is not bad at all for Goldman since it amounts to just one percent of the bank's net revenues last year. However – back then in April – the situation looked a lot more threatening. Four days after the SEC's lawsuit the Financial Services Authority (FSA) of the UK announced about the opening of an official investigation of its own into the activities of Goldman Sachs. The share price of Goldman plunged from $184.92 on April 14 to $145.20 on April 30 reflecting a highly damaging effect of bad publicity.

More unprecedented events followed. On April 27 seven witnesses – two former employees and five current top managers of Goldman including its CEO Lloyd Blankfein - were called to testify in the Senate for the hearing "Wall Street and the Financial Crisis: The Role of Investment Banks". Ten hours of intense interrogation – that's how it looked when shown live on Bloomberg TV - during which the Senators asked a lot of angry questions and hardly received any meaningful answers. Some information that had been disclosed turned out to be so shockingly revealing that it spoke enough for itself. Like, for example, an e-mail sent to a friend by Fabrice Tourre, the Goldman executive who was directly responsible for the Abacus deal: "More and more leverage in the system.The whole building is about to collapse anytime now… Only potential survivor, the fabulous Fab… standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all of the implications of those monstruosities!!!" The members of the Senate committee had every right to be outraged.

The situation was growing rather tense: bankers started to feel that their position was losing strength, but they still kept to the principle "All or Nothing" – not willing to make *any* compromises. We are NOT letting go of even a fraction of our business – that was their position in those days. An excellent insight into that kind of mentality provided famous interviewer Charlie Rose who has a popular daily talk show on Bloomberg TV. Discussing on April 30 with Goldman CEO Lloyd Blankfein the possible consequences for him of the new financial regulation Charlie Rose asked: "In the worst case scenario – meaning you will lose the whole business of credit default swaps – to what extent will it affect Goldman? How much will you lose?" And when Blankfein replied: "Around five percent" Charlie couldn't help but saying: "Oh, just that…" – which provoked a highly agitated remark on Blankfein's part showing that he is prepared to – so to speak - fight to the death.

It won't be difficult to understand why five percent means so much to Blankfein if we look at the scale of operations in the OTC market. Over-the-counter derivatives became the most controversial and difficult issue of the U.S. financial reform for a good reason: they represent a market of *$615 trillion*. This is the "notional outstanding amount", or the official OTC market size for 2009 published by the Bank for International Settlements. To illustrate what this number means we'll just mention this: it is 10 times more than the world GDP and 14 times more than the world stock market. What kind of financial instruments are we exactly talking about here? The bulk of it is made up of swap transactions of all kinds: interest rate swaps, credit default swaps, currency swaps, commodity swaps and equity swaps. In total, swaps take up almost 67 percent of the OTC derivatives market – which will be a whooping $412 trillion. Another 21 percent of the total - $129 trillion – represent other types of OTC derivatives: forward contracts and options. In fact, they are pretty similar to swaps, only slightly different, so for the purposes of the financial law all OTC derivatives are actually referred to as "swaps". Remarkably 12 percent of the total appears in the BIS derivatives statistics as "unallocated", which once again illustrates how deliberately complicated these instruments are – even for the specialists.

OTC derivatives market is dominated by largest banks. It is one of their most lucrative businesses. U.S. commercial banks held derivatives with a notional value of $216.5 trillion in the first quarter of 2010, according to the Report on Bank Trading and Derivatives Activities issued by the Office of the Comptroller of the Currency. While there are currently 1,050 U.S. banks involved in derivatives activities, this business continues to be monopolized by a very small group of large financial institutions. Five leading banks - JPMorgan Chase & Co., Citigroup Inc., Bank of America Corp., Goldman Sachs Group Inc. and Morgan Stanley - hold 97 percent of that total.

The original proposal in the US financial reform bill (made by Senator Lincoln, an Arkansas Democrat who is chairman of the Senate Agriculture Committee) would have banned all swaps trading by commercial banks, but of course it never had a chance to pass. In fact, even President Obama in his initial speech – back in June 2009 – only mentioned the notorious credit default swaps, which he said "have threatened the entire financial system". CDS have been blamed for playing a substantial role in triggering the credit crisis of September 2008. In March this year they were again at the centre of political discussions when during his official visit to the U.S. Greece's Prime Minister George Papandreou demanded to forbid CDS trading on the grounds that the massive speculation in this market undermines the credit status of his country. Credit default swaps account for a "modest" 5 percent share of the OTC derivatives trading, but let's not forget that behind this five percent stands a financial market of $32 trillion.

So – now that the legislative discussions have come to their end and the historical financial regulatory reform bill has been signed by the U.S. President – what finally happened with the OTC derivatives business? What kind of a compromise has been reached between lawmakers and bankers? How much of their lucrative derivative business will the banks have to give up?

As it turns out, the banks will have to give up (i.e. put in an affiliate) all business related to: commodity derivatives (all except gold and silver), all equity swaps and certain credit default swaps (those which are based on *non*-investment grade entities). May sound like a lot at first glance, but in fact, the above mentioned instruments represent no more than three percent of the world OTC derivatives market. In other words, the banks will give up *pretty much nothing*. And which derivatives will the banks continue to be allowed to deal? According to the new law, the banks may retain: interest rate swaps, currency swaps, certain credit default swaps (those which are based on investment grade entities), gold and silver swaps, also instruments hedging for the banks' own risk. In other words, as far as their derivatives business is concerned the banks will keep *pretty much everything*.