

# Structured Finance Newsletter

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## TRANSPARENCY - OTC DERIVATIVES REGULATION

In June 2009, the Treasury Department released a white paper entitled *Financial Regulatory Reform* that prescribed mandatory clearing for all standardized over-the-counter (OTC) derivatives and more stringent capital and margin requirements for market participants. Since that time, the House Financial Services Committee, Senate Banking Committee and Senate Agriculture, Nutrition and Forestry Committee (the Agriculture Committee) have each approved schemes for regulating derivatives. These proposals differ in many details, but do reach commonality on the need for any derivatives regulation to be comprehensive without critically restricting access to capital for creditworthy borrowers.

On April 16, 2010, the Agriculture Committee Chairman Blanche Lincoln (D. Ark.) unveiled a proposal to regulate the OTC derivatives market entitled *The Wall Street Transparency and Accountability Act of 2010*, as amended. The Lincoln Bill, as it has commonly been referred, seeks to provide transparency to the derivatives markets and create safeguards capable of protecting the financial system from the type of calamity that imperiled capital markets in 2008. On April 21, 2010, the Agriculture Committee marked up and referred the bill to the full Senate, by a vote of 13 to 8.

The Lincoln Bill is now subject to consideration by the full U.S. Senate, creating the potential for it to be debated along side, or folded within, the broader financial reform legislation (the Dodd Bill) authored and supported by Senator Christopher Dodd (D.-Conn.), the Chairman of the U.S. Banking and Finance Committee. Currently, regulation of the derivatives market had been omitted from the Dodd Bill with a placeholder noted which may be addressed later. While differing somewhat in specificity, the regulatory alternatives discussed thus far each included certain central themes which include:

- Bringing greater transparency to the OTC derivatives market
- Reducing systemic risk by requiring mandatory trading and clearing
- Eliminating future bailouts
- Addressing "too big to fail"
- Closing loopholes that allow for a shadow credit market

Legislators and regulators have also cited that achieving these goals without impairing a recovering, but fragile, financial industry is critical. Of great concern to banks and other capital markets participants is whether the expected regulation would cause financial institutions to abandon or spin-off their derivatives trading operations. Proposals have ranged from an unambiguous prohibition on proprietary derivatives trading activities, e.g. a form of the "Volker Rule", with requirements that banks and other entities that engage in swap trading be ineligible for Federal assistance in the event of a bail-out (which, along with capital reserving requirements, are proposed in the Lincoln Bill). While many have argued that additional oversight is necessary to avoid future financial crises, some have cited that additional regulation would be detrimental to the economy by driving up the cost of lending and driving financial business to more favorable regulatory regimes outside of the U.S. Some have even suggested that too rigid regulations that impose strict capital reserve requirements could put too much pressure on financial markets. Consequently, the debate on financial reform will include a discussion on regulation of OTC derivatives market, regardless of whether it is the Lincoln Bill, in its current or amended form, or some newly drafted legislation that is ultimately enacted. DBRS will continue to follow and comment on this matter and its potential impacts on the structured finance market.

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