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Peterson Says ‘Naked’ Credit Swaps Ban Not Permanent

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Collin Peterson, chairman of the House Agriculture Committee, said his proposal to ban a majority of the $28 trillion credit-default swap market wouldn’t be permanent and is meant to complement a restriction on short sales of stock imposed by the Securities and Exchange Commission.

The SEC required in July that anyone selling stock short first “borrow or arrange to borrow” the securities and then deliver them by the settlement date. That rule, which applied to shares in 19 companies including Citigroup Inc., JPMorgan Chase & Co. and UBS AG, eventually lapsed.

“If you allow the naked short selling in CDS when you have a ban on selling stock, you are exposing people to a situation where they can’t protect themselves,” said Peterson, a Minnesota Democrat, in an interview today. “It would blink on and off based on what the SEC does.”

In October, the SEC passed a new rule requiring brokers that clear trades to deliver borrowed shares to buyers by the settlement date. If they don’t deliver the shares, then they have to immediately obtain them to close out the trade. That rule expires July 31.

Peterson’s draft bill would prohibit a credit-default swap trade unless the investors owned the underlying bonds. As much as 80 percent of the credit-default swap market is conducted by investors who don’t own the underlying debt, according to Eric Dinallo, superintendent of the New York Department of Insurance.

Clearinghouse Rule

Peterson’s committee held a hearing on the draft bill today. The draft would also force U.S. trades in the $684 trillion over-the-counter derivatives markets to be processed by a clearinghouse.

U.S. regulators and politicians are stepping up pressure on banks to use clearinghouses and agree to increased oversight of the markets to improve transparency amid a credit crisis that began in 2007. Bad bets on credit-default swaps contributed to the collapse and government rescue of American International Group Inc. in September.

The Futures Industry Association, which represents banks and brokers active in the exchange-traded derivatives market, opposes parts of Peterson’s draft bill, said President John Damgard.

The draft “would remove liquidity from markets at just the wrong time for struggling small businesses” by increasing the cost of hedging and would make active trading more difficult, he told the House Agriculture Committee.

Risk in the Open

Peterson said his main goal was to force all the risk on banks’ balance sheets into the open by pushing the clearinghouse structure for OTC trading.

“If people are going to do this, then the risk needs to be identified at the time the transaction is done” by using margin payments and collateral to back positions, he said in the interview. “Clearing will do this” and for the contracts that can’t be cleared “it shouldn’t be done in the first place,” he said.

Representative Frank Lucas, the Republican ranking member on the committee from Oklahoma, declined to say if he supported using a clearinghouse to process all OTC trades. “I think we can agree that we need more transparency in the system, and that a majority of these instruments should go through the clearing process,” he said in an interview.

“I’m still hedging my bets” on supporting the bill in its current form, he said. “You always have to be concerned about unintended consequences.”

Transparency

A clearinghouse increases transparency in a market by establishing prices for contracts. It also gives regulators a single venue to oversee to monitor trading risks and position size.

“We are very concerned that limiting participation in the credit derivatives market to entities with a direct interest in the credit being protected, i.e. elimination of naked interest, will kill the CDS market,” said Michael Gooch, chief executive officer of GFI Group Inc.

Peterson said some banks are resisting his efforts to clear all OTC contracts.

“I don’t really know where some of these folks are coming from,” he said in the interview. “My sense is that they think everything is fine and we shouldn’t regulate them. I have news for them. The public’s not going to stand for that.”

He said he didn’t want “to kill” OTC trading, but that the banks “have not demonstrated much integrity in what they’ve done so far.”