

The Dodd-Frank rule that Congress just repealed, known as the “swaps push-out rule,” would have required that most derivatives-trading activities occur outside of government-insured banks. If a bank fails, the government stands behind most deposits. Though it does not formally guarantee anything else, it usually finds it easiest and quickest to bail out the entire bank – including its derivatives facility. If, however, derivatives are no longer embedded in the guaranteed bank, the government could more easily bail out a bank, while leaving the derivatives subsidiary to fend for itself.

This sub rosa government indemnification of major banks’ derivatives portfolios undermines financial stability. If a major bank defaults on its derivative trades, the banks with which it has traded could also fail. If several large, interconnected derivatives-trading banks collapse simultaneously, the financial system could be paralyzed, damaging the real economy – again.

And it is the large banks that are building up their derivatives portfolios the most. Indeed, this is another pernicious, albeit subtle, effect of the sub rosa guarantee of banks’ derivatives portfolios: the knowledge that, if a large bank fails, it will probably receive a government bailout – including for its derivatives desk – spurs traders to focus their dealings on big banks. Smaller independent dealers that the government could allow to fail thus become less appealing.

This explains, at least partly, why a handful of mega-banks in the US – namely, Citibank, Goldman Sachs, Bank of America, and Morgan Stanley – handle the bulk of derivatives trading. That creates a vicious cycle: the bailout option for too-big-to-fail banks concentrates the derivatives market among a few major institutions, increasing further their systemic importance.

The push-out rule sought to break this cycle. By separating derivatives trading from government-insured banks, it would have effectively eliminated the sub rosa subsidy. While the government would still have to back deposits for crisis-stricken banks – even if that meant bailing out the entire institution – it would have had the option of allowing the derivatives trading desks, functioning within separate organizations, to flounder.

This would have helped to undermine the perception that large derivatives dealers are invulnerable, thereby reducing their trading advantage. Mid-size dealers that could fail without causing excessive economic damage would get more business. And the financial sector would become more balanced – and less risky.

Against this background, the repeal of the push-out rule was a mistake.

It is possible that US regulators (and Congress) are so confident in the other steps they have taken to safeguard the financial system that they no longer believe this extra protective layer is necessary. But Citigroup’s success in lobbying for the rule’s repeal could also signal that regulatory efforts to mitigate systemic financial risk have reached the high-water mark in the US. If Citigroup – a poorly managed operation that had to be bailed out in the last crisis – could compel Congress to abandon such a rule, it is

reasonable to ask whether the political tides have shifted, and financial regulation will not be tightened further. Perhaps, with each budget bill, Dodd-Frank will be rolled back further.

This outcome is not inevitable. The repeal can – and should induce regulators to reassess their approach. Specifically, they should revisit the consensus that banks will become gradually safer, and their required capital should amount to no more than 10% of their assets. If the banks are successfully lobbying for the right to pursue riskier activities, regulators should consider raising their capital requirements.

Only a few years have passed since the last financial crisis – and its effects are still being felt. Yet US lawmakers are already forgetting its lessons.