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The SEC's Credit Default Swaps Disclosure Proposal Could Imperil Banks' Ability to Manage Risk Through the Credit Default Swap Market, Undermining Bank Safety and Soundness

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Credit default swaps are a crucial tool banks use to manage risk. The SEC's proposed Rule 10B-1, which would require market participants to publicly disclose particular positions in single-name or narrow-based index credit default swaps (CDS), and certain other swaps, would threaten banks' ability to access the credit default swaps market for risk management purposes.

- **What are credit default swaps?** Credit default swaps are derivatives that enable a market participant to hedge, or insure, against the risk of loss for an underlying investment. For example, say an investor buys a 10-year corporate bond and wants to insure against the risk that the bond issuer will default by failing to make interest payments or repaying the principal amount. The investor can enter into a CDS contract with another market participant whereby, for a fee paid by the investor, that participant agrees to make the investor whole if the bond issuer defaults.
- **What do banks use credit default swaps used for?** Banks use CDS to hedge risk efficiently and cost-effectively, freeing up space to offer more credit to their customers while mitigating risk and meeting stringent capital requirements. CDS can allow banks more flexibility to serve their customers' credit needs.
- **Are credit default swaps regulated?** Yes. Dodd-Frank created a comprehensive regulatory regime for credit default swaps that the SEC began implementing in November of 2021. CDS contracts are subject to real time public reporting and margin requirements, and it requires dealers to register with the SEC, subjecting them to capital, business conduct and risk management requirements.
- **What's happening at the SEC?** The SEC originally published its Rule 10B-1 proposal in December 2021. The agency's rationale for the proposal is that more disclosure is beneficial. However, too much disclosure – especially in the granular way contemplated in the proposal – is harmful to bank risk management. It's important to strike the right balance.
- **What could go wrong:** The proposed rule could jeopardize banks' reliance on single-name and narrow-based index credit default swaps to hedge credit risk by requiring new, granular position-level public disclosures. These disclosures would harm bank risk management options by making market-moving information known to the market, inhibiting the bank's dealer counterparties from entering into offsetting transactions as a hedge. Sophisticated trading firms and speculators could use the disclosed information to "front-run" the transactions. This creates a strong disincentive for market makers to provide liquidity in CDS and could result in a further chilling of the already limited CDS market. Ultimately, the rule would make it harder and more costly for banks to hedge risk, and for dealers to provide credit risk protection.
- **Discretion:** These disclosures could violate client confidentiality agreements for banks or otherwise hurt client relationships.
    - Public information about CDS positions could fuel the rumor mill – for example, even if a bank buys CDS simply as a prudent risk management tactic, changes in the market could suggest credit quality issues with the underlying entity – and increase risk in the markets.
    - This information would paint a misleading and incomplete portrait of a bank's loan portfolio compared to the aggregated information provided to regulators and in publicly available call reports.

There's a Better Way.

Safer alternatives to the position-level disclosure proposal can accomplish regulators' goals in a way that preserves banks' risk management toolkit.

- Reporting SBS position information confidentially to the SEC and solely for regulatory purposes.
- Using that information to create a gradual and calibrated approach to any public disclosures, similar to how regulators have approached public transparency requirements for other securities markets.
- Considering publication of aggregated, anonymized information on an appropriately delayed basis, similar to the CFTC's futures reports. This would allow banks and other market participants to monitor for concentrations or meaningful trends without having the same impact as individual, position-level disclosure.

Bottom Line:

There must be a better balance between the benefits of public disclosure in the CDS markets and the ability of banks to manage credit risk. The current proposal gets it wrong, and risks sacrificing bank safety and soundness on the altar of public disclosure. The SEC should re-issue a proposal that strikes the right balance.