Out of the Black Hole

Reining in the reckless market in over-the-counter derivatives.

MICHAEL GREENBERGER | *April 26, 2010*

Former Commodity Futures Trading Commission Chair Brooksley Born (AP Photo/Lisa Poole)

In September 2008, the United States faced what President Barack Obama called the "most profound economic emergency since the Great Depression." A mortgage crisis begat a credit crisis, shaking the entire financial system and sending the U.S. economy into what has been called the Great Recession.

This crisis was caused in large part by the opaque and unregulated over-the-counter (OTC) derivatives, or "swaps," market, which was then estimated to have a value of almost $600 trillion, or 10 times the world's gross domestic product. Approximately one-tenth of the unregulated OTC market was made up of the now-infamous credit-default swaps, a product that Wall Street sold to "insure" sub-prime mortgage investments but which lacked regulation and, therefore, the capital required to support these "guarantees." When sub-prime investments failed, the "insurance" payments were triggered. Only the multitrillion-dollar U.S. taxpayer interventions to save Wall Street prevented a worldwide depression.

This crisis was the direct result of the deliberate dismantling of regulatory safeguards. After the collapse of the equity markets and then the banking system between 1929 and 1933, the Roosevelt administration drove the passage of the Securities Acts of 1933 and 1934 to regulate securities, and the Commodity Exchange Act of 1936 to regulate futures transactions. These landmark legislative efforts established eight classic regulatory norms to prevent systemic financial collapse in financial markets, including transparency of prices, record-keeping, capital adequacy, full disclosure, anti-fraud and anti-manipulation prohibitions, regulation of intermediaries, private enforcement through litigation, and the federally supervised self-regulation of financial exchanges.

These eight guidelines still govern ordinary stock markets today, and it is noteworthy that malpractices in conventional securities played no role in the 2008 systemic worldwide collapse. These norms had governed the futures markets until 1993 when Wall Street insisted that OTC derivatives be exempt from those traditional regulations. In that year, an accommodating Commodity Futures Trading Commission (CFTC) created an exemption for a limited class of OTC derivatives from classic market regulation.

However, Wall Street almost immediately became dissatisfied with the constraints of the 1993 exemption. Wall Street wanted to sell a far broader range of profitable swaps that could not meet the 1993 restrictions. By 1998, the market grew to over $80 trillion, with swaps dealers conducting most of that business in complete disregard of controlling law.

As a result, in May 1998, the CFTC, under the leadership of then-Chair Brooksley Born, issued a "concept release" inviting public comment on how this multitrillion-dollar unsupervised and opaque market should be regulated. The release was premised on several systemically destabilizing events that had been caused by unregulated OTC swaps.

At the behest of Wall Street, a Republican-controlled Congress passed legislation enjoining Born from this work and then, on the recommendation of the senior Clinton economic team including among others then-Secretary of the Treasury Larry Summers and Fed Chair Alan Greenspan, rushed through a 262-page rider to an 11,000-page omnibus appropriations bill on Dec. 15, 2000 -- the last day of a lame-duck session. The rider, the Commodity Futures Modernization Act (CFMA), removed what was by then the $94 trillion OTC-derivative market from all federal regulation.

In one fell swoop, the OTC market was exempt from the traditional market regulatory controls, including capital-adequacy requirements; reporting and disclosure; regulation of intermediaries; supervised self-regulation; and bars on fraud and manipulation. Overnight, the entire OTC market was legitimized as a private market, wholly opaque to financial regulators and market observers.

To understand the central role played by OTC derivatives in the recent meltdown, a review of sub-prime securitization is necessary. In brief, the securitization of sub-prime mortgage loans evolved to include simple mortgage-backed securities within highly complex collateralized-debt obligations. CDOs packaged huge numbers of mortgage-backed securities, then sliced up those instruments sorted by supposed degree of risk for sale to investors, the so-called tranches. This process, in theory, would offer diversified and graduated risk options to sub-prime mortgage investors.

However, investors became unmoored from the essential risk underlying loans to noncredit-worthy individuals by the continuous reframing of the form of risk (from sub-prime mortgages to mortgage-backed securities to CDOs); the misleading assurances given by credit-rating agencies; and, most important, the undercapitalized "insurance" offered on CDOs in the form of credit-default swaps -- the poster child for unregulated OTC derivatives.

That "swap" was the exchange by one counter party of a "premium" for the other counterparty's "guarantee" of the financial viability of a CDO. While credit-default swaps have all the hallmarks of insurance, issuers of these swaps in the insurance industry were urged not to call it "insurance," because the transactions would be subject to state insurance law, which would have required, among other protections, adequate capital underpinning the guarantees. Swaps fell into the regulatory black hole created by the CFMA. Federal regulators had no knowledge of, or control over, the multitrillion-dollar world of swaps.

Because a credit-default swap was deemed neither insurance nor a transaction otherwise regulated by the federal government, issuers were not required to set aside adequate capital reserves to stand behind the guarantee of CDOs. The issuers of the swaps were beguiled by the utopian view (supported by ill-considered mathematical algorithms) that housing prices would always go up. They believed that even a borrower who could not afford a mortgage at initial closing would soon be able to extract the appreciating value in the residence to refinance and pay mortgage obligations. Under this utopian view, the writing of a credit-default swap was deemed to be risk-free. The issuers had as their goal the writing of as many swaps as possible to develop the huge cash flow from the "premiums."

To make matters worse, the swaps were deemed to be so free of risk (and so much in demand) that financial institutions began to write "naked" credit-default swaps, offering the guarantee to investors who had *no* risk in any underlying mortgage-backed instruments. (Under state insurance law, if this had been deemed insurance, rather than a swap, it would be considered insuring someone else's risk, which is flatly banned.)Naked credit-default swaps provided a method to "short" the mortgage-lending market, allowing speculators to place low-cost bets that those who could not afford mortgages would default.

The problem was further aggravated by the development of "synthetic" CDOs. Again, these synthetics were mirror images of "real" obligations, thereby allowing an investor to play "fantasy" securitization: The purchaser of a synthetic CDO did not "own" any of the underlying mortgages or securitized instruments but was simply placing a "bet" on the financial value of a real CDO being mimicked. Synthetic CDOs are also OTC derivatives and therefore not subject to federal regulation. Synthetic CDOs were also "insured" by unregulated swaps.

Because both naked swaps and synthetic CDOs were nothing more than bets on the viability of the sub-prime market, at Wall Street's behest, the CFMA banned application of state gambling laws to these transactions.

It is now well established that:

- Issuers of credit-default swaps did not have adequate capital to pay off guarantees as housing prices plummeted, thereby defying the supposedly "risk free" nature of issuing huge guarantees for relatively small premiums.
- Because credit-default swaps are private and bilateral arrangements unknown to federal regulators or market observers, the triggering of such swaps often came as a surprise to both the financial community and regulators.
- As the housing market worsened, new swap obligations were unexpectedly triggered, creating heightened uncertainty about the viability of financial institutions that had, or may have, issued these instruments, thereby leading to the tightening of credit generally.
- The issuance of "naked" credit-default swaps increased exponentially the obligations of swap underwriters, since every time a sub-prime mortgage defaults there is both the real financial loss and the additional loss derived from failed bets.

This securitization structure is present not only in the sub-prime mortgage market but in the prime mortgage market, as well as in commercial real estate, credit-card debt, and automobile and student loans. As of this writing, the financial media is filled with concerns that forfeitures in many of these markets will worsen substantially, thereby triggering many more swaps for which there will almost certainly be insufficient capital to pay the guarantees, thereby restarting the downward cycle that drove the country into recession.

In June 2009, in response to the catastrophic systemic failure caused by unregulated derivatives, the Obama administration issued a white paper proposing that all standardized OTC derivatives be subject to clearing and exchange trading. It proposed that they be overseen in accordance with the traditional dictates of market regulation that had been in place since the New Deal but were abandoned under the CFMA. The administration also recommended that "all OTC derivatives dealers and all other firms who create large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation," including the imposition of increased capital requirements, business conduct standards, and auditing requirements.

However, on Aug. 11, 2009, the Treasury Department submitted to Congress a specific legislative proposal that substantially undermined the Obama administration's June 2009 stated goal of "bring[ing] the markets for *all* OTC derivatives ... into a coherent and coordinated regulatory framework that requires transparency and improves market discipline." On Aug. 17, 2009, CFTC Chair Gary Gensler, in a letter to Congress, critiqued the Treasury's proposed loopholes as being so broad that they could "swallow up the regulation." While key legislative supporters of the Treasury proposal maintain that its loopholes only exempt 20 percent to 30 percent of the $600 trillion market, respected experts both within and outside of the Obama administration have estimated that almost 60 percent of that market will be unregulated by virtue of only *one* of the two major loopholes supported by Treasury with state gaming laws unable to stifle any of the rampant "betting" permitted within the unregulated part of the OTC market.

On Dec. 11, 2009, the House passed HR 4173, which contains derivatives language that generally follows the August 2009 Treasury proposal. As of this writing, Sen. Blanche Lincoln has, to the surprise of many observers, just circulated a bill that either eliminates or substantially limits the Treasury loopholes. The Democratic Senate majority now appears to support her effort, and President Obama has just warned wary Republicans that any financial-reform bill that does not strictly regulate the OTC market will be vetoed.

Unregulated OTC derivatives have been at the heart of systemic or near systemic collapses -- from the 1994 bankruptcy of Orange County, California; to the collapse of Long Term Capital Management in 1998; to the bankruptcy of Enron in 2001?2002; to the 2008 sub-prime meltdown; and now to an emerging European sovereign-debt crisis in which derivatives were used to disguise the extent of debts taken by nations such as Greece. After each crisis, governments worldwide proclaim that the OTC market must be regulated in the same manner as equity markets, which are dwarfed in value by OTC derivatives. However, Wall Street always deflates those aspirations with aggressive lobbying and campaign contributions. The present financial-reform regulatory effort may be the last chance to prevent the kind of crisis that was dodged in 2008 -- a worldwide depression. Wall Street and its allies must be stopped now.

To avoid further systemic and irreparable meltdowns, legislation must be enacted that requires all standardized derivatives to be guaranteed by well-capitalized clearing facilities and traded on fully transparent and well--regulated exchanges. This is what the Obama administration's June 2009 white paper promised. The president and Congress should be made to stick to that promise, or the world economy will devolve into a black hole with far greater pull than the regulatory black hole that exists for swaps.

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