

## **Commentary: The Role of SWAPs In The Financial Panic of 2008**

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There were many causes of the Financial Panic of 2008.

Most early reports blamed the sub-prime mortgage market, a story that was particularly appealing to those who believe everything should be blamed on left-wing policies intended to promote home ownership by blue collar workers. However, the numbers just don't add up. There weren't enough sub-prime mortgages issued to explain the magnitude of the crisis.

Later accounts focused on financial engineering. Lord Turner, head of London's Securities and Futures Authority (SFA), produced a cogent analysis demonstrating that through the securitization process, banks were able to reduce the capital requirements attributable to mortgage lending. This neat bit of financial engineering increased banks' profits, but greatly increased their risks of failure.

Lord Turner's analysis provided an explanation for the crisis that was more consistent with reality than the earlier sub-prime argument. The difficulty is that the focal points of the Panic were the collapse of Bear Stearns in March 2008 followed by the Lehman Brothers bankruptcy in September 2008. Bear Stearns and Lehman Brothers were investment banks, rather than commercial banks, and were not engaged in direct mortgage lending. Since neither Bear nor Lehman engaged in mortgage lending, the securitization process would not have reduced their capital requirements.

This is a story of the role SWAPs played in the crisis.

A SWAP is a contract that permits one party to trade a feature of a financial instrument without relinquishing the entire instrument. For example, suppose someone that holds a bond paying interest at a variable rate based on the London Inter-Bank Overnight Rate (LIBOR) would prefer to obtain interest at a fixed rate. Our dissatisfied holder can enter into a contract to swap the payments she would otherwise receive at a variable rate with someone who agrees to pay interest at a fixed rate. All other things being equal, most people prefer to hold debt instruments that pay interest at a fixed rate, rather than a variable rate. So, she will have to pay some amount to convince the counterparty to accept variable payments in exchange for a fixed payment stream.

The contract for such exchanges is called a SWAP. They are so common that an organization called the International Swaps and Derivatives Association (ISDA) has reduced them to cookie cutter forms. Counterparties simply have to fill in a few blanks and execute them to enter into binding agreements.

SWAPs are derivatives, which means they represent pieces of larger financial instruments. In our bond example, the SWAP represents the stream of payments to which the bond holder is entitled, but does not provide the purchaser of the payment stream to any of the other many rights of an actual bond holder. Most important, most SWAPs do not provide a counterparty with the right to collect principal on a debt instrument at maturity.

It is possible to swap any feature of a financial instrument. For example, a bond holder can sell the risk that the bond might default, in exchange for a promise that the purchaser will make good on the repayment of principal. This is essentially the basis for credit default SWAPs.

Some members of the media have described such contracts as nothing more than gambling. The person purchasing the variable payment stream, for example, might be described as betting that he will receive more money than the person who swapped for a fixed payment stream. In New York, it is illegal to place a bet that stock prices will rise or fall. However, it is not illegal to own securities or sell them short, which is defined as investing. To avoid rules prohibiting bets on stock prices, SWAPs require a counterparty that defaults to deliver the underlying financial instrument to its non-defaulting counterparty. In our example, if the person selling the right to receive a variable payment stream defaults, then she must transfer the entire bond, including the right to receive the principal, to the purchaser. Because the underlying security must be delivered in the event of default, the law defines SWAPs as securities derivatives, rather than gaming contracts.

Nonetheless, the law does not require either SWAP counterparty to actually own the security on which the SWAP is based. So, a defaulting counterparty might not own the bond that it is required to deliver. In that case, the defaulting counterparty will be required to purchase the bond to make delivery to satisfy its obligation on default. In general, the interest payable on a bond, discounted to reflect present value, will be much less than the principal amount payable at maturity. This means that a defaulting counterparty is required to deliver amounts much greater than the value of its SWAP contract.

The value of SWAPs can therefore be expressed as two numbers: The value of required payment streams and the value of the SWAP in the event of a counterparty default. The Bank for International Settlements reported that the market value of all

SWAPs, representing the aggregate value of required payment streams, in June 2007 was approximately \$11 trillion. In contrast, the notional amount, representing the value in the event of counterparty defaults, was approximately \$516 trillion.

Investment banks make a lot of their money trading SWAPs and generally hold large SWAP positions. However, they do not tie up their capital by actually holding many of the underlying bond positions. As a result, a default by a large investment bank would trigger the requirement to purchase and deliver underlying securities with a value many times that of the defaulted payment stream, a requirement that almost instantaneously would cause the bank to fail. That failure also may threaten the financial stability of the bank's counterparties, who in turn have obligations that may be tied to the defaulting bank's credit or its payment obligations.

The Federal Reserve (Fed) and Securities and Exchange Commission (SEC) have been aware of the SWAPs problem since the time of the Salomon Brothers Treasury Desk scandal in the early 1990s. Consequently, when Bear Stearns began to founder in heavy financial water, the financial regulators were unwilling to allow it to fail. Instead, a shotgun marriage was arranged with JP Morgan that required the U.S. taxpayer to finance a \$30 billion dowry. The Bush administration was heavily criticized for providing this support at taxpayer expense.

Reacting to that criticism, when Lehman Brothers became unstable, the Federal Reserve spent a great deal of time evaluating the effects of a Lehman default on Lehman's own SWAP positions and its SWAP counterparties. The Fed concluded that Lehman Brothers could fail without any serious effect on its counterparties.

However, the Fed failed to consider the fact that many prominent financial institutions held credit default SWAPs that did not have Lehman as a counterparty, but were triggered by Lehman's default. The Fed had no way of knowing this because SWAPs were unregulated, and no one was required to report their SWAPs positions to any regulator. A study of Lehman's books could not reveal the existence of SWAPs as to which Lehman was not a counterparty. When Lehman Brothers was allowed to fail, the magnitude of the resulting SWAP obligations caused the global financial system to come to a halt, requiring major intervention by the U.S. taxpayers and by central banks throughout the world to prevent a complete economic collapse. And the rest is history.

Admittedly, this is only part of the story. Money market funds with large positions in Lehman Brothers commercial paper also were involved. Securitization practices reduced banking capital to paper-thin levels, far below the dictates of safe banking practices. Sub-prime mortgage defaults were the tinder that set the rain-starved forest alight.

In the case of SWAPs, it is clear that the regulators lacked the information necessary to make the right decisions about Lehman Brothers. If the regulators had been aware of the credit default SWAPs on Lehman bonds held by AIG, for example, they might have tried to resolve that issue before letting Lehman fail.

In an effort to address this gap in regulatory information, the Dodd-Frank Wall Street Reform and Consumer Protection Act grants to the Commodity Futures Trading Commission (CFTC) the authority to regulate all SWAPs other than “securities-based SWAPs,” which will be regulated by the SEC. All SWAPs transactions will end up being reported to one agency or the other.

On November 19, 2010, the SEC proposed rules to implement trade reporting for the securities-based SWAPs portion of this oversight. The proposal would require every transaction in securities-based SWAPs to be reported to a security-based SWAP data repository. Most transactions would be reported in real-time, while some relatively unusual custom products would be reported within 24 hours.

The proposed rules go much farther than required to provide regulators with the information necessary to make life or death decisions about regulated financial institutions. The rules will require real time public dissemination of SWAPs data, which should foster competition and reduce industry profitability, but is not necessary to provide regulators with the information they need to make good decisions. Moreover, in many ways, the proposal represents a regulator’s wish list for transactional data production and, if implemented, will likely represent a model for regulatory production of information regarding other securities transactions. I intend to explore the interesting implications of the proposal’s data production features in future columns.

Except for fringe groups who believe that there should be no regulation of financial institutions other than the enforcement of contracts by courts, no one doubts that regulators need to know how many SWAPs positions are out there at any particular time, who holds them, and the nature of the financial instruments from which they are derived. The SEC’s proposal, together with the rules that will follow from the CFTC, eventually will close a gaping hole in the U.S. financial regulatory system.

The information derived from this exercise should enable regulators to permit a failing financial institution to die without bringing the global economy to a halt or using taxpayer funds to keep the patient alive. On the other hand, regulators will also have a much more difficult time explaining why they failed to anticipate the consequences of the next “Lehman Brothers” failure.

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