The Evil Credit Default Swaps

By Stephen J Nelson; The Nelson Law Firm, LLC

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When crisis strikes, humans naturally seek a simple explanation. In turn, simple explanations require simple causes. Until recently, sub-prime mortgages were assigned much of the blame for the Panic of 2008. Now, it seems that credit default swaps have taken their place in the dock.

Any swap, as the name suggests, involves some sort of barter. Suppose, for example, that someone is holding a bond that pays a variable rate of interest. For any number of reasons, she may prefer to receive a fixed rate of interest. So, she will "swap" her right to receive a variable rate of interest with someone willing to pay her, in exchange for the variable interest paid on a particular bond, a fixed rate of interest. This sort of interest rate swap is extremely common.

A credit default swap involves a slightly different, but nonetheless similar exchange. This instrument reflects the fact that any bond issued in the corporate debt market has an interest rate comprised of two elements: The "riskless rate of return" and the "risk of default."

The riskless rate of return is based on the principle that no one will lend money unless they are paid something to do it. Economists frequently describe this as a preference for current consumption as compared to future consumption. The riskless rate of return is the amount that a lender will need to receive in order to forego current consumption. This business of consumption has always bothered me, since most of the institutions that engage in lending in significant amounts are not consumers. Perhaps it is better to say that the institution making a loan foregoes the opportunity to obtain potentially higher rates of interest before the loan matures or takes the risk that the loaned money will not be available for other unanticipated purposes, such as paying back depositors.

In any event, all of this assumes that the lender is absolutely certain that his money will be returned to him after some period of time and only assumes the risk that circumstances will change in the interim. This "riskless return" is only possible when the Federal Government is the borrower, although the recent case of Iceland demonstrates that even national governments may default on their loans from time to time. So, every bond issued by entities other than the Federal Government has an interest rate that is composed of the "riskless rate," roughly equivalent to the rate on T-Bills of similar maturities, and the "default risk," which reflects the risk that

the issuer of the bond will default. A credit default swap essentially trades part of the interest that reflects the risk of default for a less risky rate of return.

So far, so boring. What makes things interesting is that neither counterparty to a swap needs to actually own the underlying instrument. In fact, many more swaps for a particular bond can be written than there are bonds. But, it is a feature of all swap contracts that when the issuer of the bond on which a credit default swap defaults, the swap counterparty that is the obligor must tender the underlying bond. Moreover, a counterparty may default under a swap, even when the issuer has not. For example, swap contracts frequently provide that if a swap counterparty has a payment default on one of its obligations, or suffers a serious regulatory sanction, then this counterparty default will also trigger an obligation to tender the underlying bond. However, swap obligors rarely tender the bond. Instead, they pay in cash the difference between the principal (or par) amount of the bond and its market value (which may be zero). This obligation to ante up is sometimes called the "nominal amount."

The duty to tender the underlying instrument, or the nominal amount, is an extremely important aspect of most derivative contracts. For one thing, it distinguishes swaps and other derivatives from gaming contracts, which are just a naked promise to pay money upon the occurrence of a certain event, such as the appearance of the number 3 on a rotating wheel. Nonetheless, the nominal amount is the source of endless amounts of trouble.

Every derivatives lawyer will tell you that it is never expected that very many issuers will actually default; rather, the market price of credit default swaps is expected to fluctuate as the market evaluates the risk of any particular issuer's default. So, when a lot of issuers default at the same time, swap obligors suddenly have much larger obligations to pay the nominal amount than were ever intended. Since the aggregate nominal amount of all credit default swaps written on any particular bond may be many multiples of the actual amount of the debt, any particular issuer's default may have a multiplier effect, causing much more loss than the actual debt default.

An issuer's default then may cause the obligor on a swap contract to default on obligations to its counterparties. This counterparty default then invokes obligations to pay the nominal amount on the obligor's other swap contracts, such as interest rate swaps. The result may be cascading defaults, as the failure of one obligor may result in the collapse of its swap counterparties. Institutions that have a large swaps book will suddenly find that their balance sheet assets have deteriorated and their liabilities have increased dramatically. From all that appears, this is the phenomenon that brought AIG to its knees.

The amounts involved are truly enormous. The nominal amount of credit default swaps alone, which would be the amount paid if all of the bonds defaulted and their market value was reduced to zero, is estimated at somewhere between $40 and $80 trillion, more than the combined domestic product of every nation on earth. The estimate for the nominal amount of all swaps is somewhere in the neighborhood of $500 trillion. The total nominal amount for all derivative contracts, which would include stock options and securities futures, is much, much larger.

Of course, it is very unlikely that every bond on which a swap is written would default. But any series of defaults that would cause a ten percent payment under all outstanding credit default swaps would result in swap counterparty payments equal to $500 billion, which is roughly equal to the gross domestic product of Sweden, the 18th largest economy in the world.

Other than the courts, which regulate all private contracts, no federal or state agency regulates swaps. As a result, they were written by hedge funds and other unregulated entities with reckless abandon. Now that these "instruments of mass financial destruction," to quote a phrase coined by Warren Buffet, have blasted large holes in the global financial services industry, as well as the taxpayer's purse, Congress is paying attention, and boat loads of regulators have stepped up to the plate offering reasons why the regulation of swaps should fall within their purview.

The Commodity Futures Trading Commission (CFTC), which is charged with the regulation of futures, was the first to propose that it should regulate swaps. In 1997, CFTC Chairperson Brooksley Born predicted with remarkable prescience that unfettered trading in swaps could "threaten our regulated markets or, indeed, our economy without any federal agency knowing about it." She argued that swaps were futures and should be regulated by the CFTC. The Fed Chairman at the time, Arthur Greenspan, and Larry Summers, of Clinton's Treasury Department, strongly disagreed, and Arthur Levitt, then Chairman of the SEC, seconded their motion. Congress forbade Ms. Born from undertaking any further action to regulate swaps, and she departed from the CFTC a year later.

Superintendent Eric Dinallo of The New York State Insurance Department, in testimony before The Senate Committee on Agriculture, Nutrition, and Forestry on October 14, 2008, argued that swaps are really insurance contracts and should therefore be regulated by his office. I am grateful to Bruce Kraus, a senior partner at Wilkie, Farr & Gallagher, and an occasional reader of this column, who kindly sent me a transcript of Mr. Dinallo's testimony.

Mr. Dinallo's remarks make mighty interesting reading. Mr. Dinallo thinks that the promise to pay money if something bad happens smells a lot like insurance, in the same way that insurers promise to pay money if your house burns down. The

regulation of insurance is left to the 50 States, rather than the federal government. So, the characterization of swaps as insurance contracts would place them under Mr. Dinallo's watchful eye, at least to the extent that one of the counter-parties is a resident of New York. It is estimated that this logic would bring roughly one-third of all credit default swaps under the supervision of New York's Department of Insurance.

Mr. Dinallo further contends that when a bondholder enters into a credit default swap, it is a socially useful hedge of risk; however, when people who don't own the bond enter into the swap, it is gambling and injects more risk into the system. Reaching back into history, he discusses New York's experience with "bucket shops," enterprises that served as counterparties for people who wished to speculate on securities or commodities. These enterprises were blamed for the Panic of 1907 and banned thereafter in most of the 50 states.

The problem with Mr. Dinallo's argument is that it proves too much. Any position taken as a hedge might be considered a form of insurance because hedges are intended to reduce risk. Derivatives are often used to hedge other positions. So, there is no logical way to limit Mr. Dinallo's reasoning to swaps or even credit default swaps. Any derivative instrument would be banned, or perhaps regulated as insurance, using Mr. Dinallo's reasoning, including ordinary stock options and futures.

In fact, the "bucket shop" argument was originally used to advocate a ban on stock options. Long ago, the courts decided that derivatives were not gaming contracts, provided that the obligor promised to deliver the underlying instrument under certain conditions. We have never required derivatives counterparties to actually have a position in the underlying security because such a rule would pretty much do away with any business in derivatives. Even that most radical of Congressional sessions that convened in 1932 was unwilling to go that far.

Not to be outdone, SEC Chairman Christopher Cox published an article dealing with credit default swaps on the SEC's website that was written for an Op-Ed column in the New York Times. Mr. Cox has been the target of much criticism of late, most recently being compared in Congress to the hapless Bill Buckner of the Boston Red Sox, and would very much like to see attention diverted elsewhere. For what it's worth, I think history has not been fair to Mr. Buckner, who was a fine ballplayer and a true professional. In any event, Mr. Cox's article laments the lack of regulation of credit default swaps. At the same time that Congress prohibited the regulation of swaps by the CFTC, it forbade the SEC to regulate them. So, whatever fall-out results from the failure to regulate credit default swaps will most likely fall on someone other than Mr. Cox.

Mr. Cox thinks the problem with credit default swaps was caused by fraud and unfair practices. He also thinks that they provide a powerful incentive to manipulate markets by generating rumors about issuer defaults because that might increase the value of a swap held by the rumor-mongerer. But, the SEC has not uncovered any examples of this sort of manipulative behavior, so far.

Mr. Cox would favor more disclosure to cure the problem. So, swaps dealers would be required to publicly report their trades and positions. There would be central counterparties, similar to the Options Clearing Corporation, that would eliminate the mystery of who is on the other side of the trade when it is time to settle. Mr. Cox would place credit default swaps under the control of the SEC.

Fraud? Swaps are not retail investments. As far as I can tell, the vast majority of the persons who trafficked in swaps were sophisticated investment managers who had a complete understanding of the financial obligations they were creating. They may not have been capable of anticipating all of the consequences of their actions, but then neither did the famous Chairman Greenspan. It is fantastic to claim that swaps were sold through unfair practices. Similarly, while rumors might be effective in moving equity prices, it is difficult to cause bond defaults with rumors. It is truly hard to understand how more disclosure would have prevented, or even had much of an effect on, the current calamitous outcome.

The contest over who should regulate swaps is typical of the turf wars generated by our current system of regulation and is at least one of the reasons why we are in this fix.

The problem with swaps, and most other financial derivatives, is that too many of them were issued. Neither the SEC, nor the CFTC, are very good at placing limits on the issuance of derivatives. And, the idea of regulating swaps by 50 state insurance commissioners is impractical in today's global economy.

It seems to me that the control of derivatives, like other forms of credit, belongs in the area of safety and soundness. As it happens, the Fed and other banking regulators know a great deal about keeping financial institutions sound. This expertise should be used to limit the production of swaps, and for that matter, options and other financial derivatives.

On the other hand, the SEC and the CFTC should be merged, and any sales practice regulation should belong to a merged SEC-CFTC, because that is their field of expertise. As it happens, the SEC has promulgated rules governing options disclosure, and the CFTC has its own set of rules for futures disclosure, which have done a fairly good job of keeping the investing public informed as to the risks of investing in options and futures. To the extent that swaps ever become an interesting investment to the retail customer, I feel confident that the SEC is up to

the task of requiring appropriate risk disclosure for these instruments. If market rumors are the problem, the SEC is up to the task of putting market manipulators in jail.

It may seem strange that I would favor putting swaps under the Fed's control, when that institution has famously opposed their regulation. I think many of the current problems were created because the Fed was not required to regulate these instruments, or for that matter, asset-backed securities and the other pooled investment vehicles that are at the bottom of this crisis. So, it was easy for Chairman Greenspan to argue there wasn't anything he could usefully do to prick an ever-growing bubble. This would be a much different tale if Chairman Greenspan and the Fed had been made accountable.

At least, we would have a much better sense of who deserves to be hanged.