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Interview notes - Michael Greenberger - Derivatives

Michael Greenberger

American International Group, Inc. (AIG)

Wendy Edelberg

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Recommended Citation
Greenberger, Michael; American International Group, Inc. (AIG); and Edelberg, Wendy, "Interview notes - Michael Greenberger - Derivatives" (2010). *YPFS Documents (Series 1)*. 6125.
https://elischolar.library.yale.edu/ypfs-documents/6125

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4/12/10 Interview: Michael Greenberger, University of Maryland School of Law, ex-CFTC, on derivatives

- Look at how the futures market developed; why it got regulated during the New Deal; how the instruments changed over the years; and the CFMA.
- Obviously CDS played a very big role, but I don't think you can understand what caused the meltdown without understanding the history.
- ➔ Read Greenberger and Partnoy articles in the Make Markets Be Markets book.
- Michael Lewis book: I've been saying this since the summer of 2007.
- ➔*An Introduction to Commodity Futures and Options*, Battley.

Bubble in basic commodities

- Focus in Congress in Summer 2008. House passed a bill, Senate didn't.
- Use of swaps to unmoor prices from fundamentals; price of oil summer 2006-2008-2009.
- It was fortunate that prices were lower in early 2009. $147 to $33.
- All of the financial reform regulation has ways to control swaps: commodity index swaps issued by JPMC and GS. It's like a casino; money doesn't go into anyone's hands except for Goldman etc. That plays back into the real-world spot market. When gas was at $4 per gallon, no lobbyist had any power. Both houses passed laws; Senate didn't really pass.
- Gensler said we're going to control this, it's all speculation.
- OPEC is most upset about this.
- Testified six times in Congress in summer 2008.
- When oil was at $147, Goldman analysts were saying $200. When they take in the money, the investor is long; they are short, because they'll have to pay them if the price goes up. They go into regulated futures market and buy every futures contract they can get.
- ICE was an unregulated exchange through "Enron loophole" in CFMA.
- These are not intended to be speculative markets. Farmers understood if they didn't limit speculation, their ability to hedge went haywire. The basic concept of CEA was that the CFTC can set limits on the amount of speculative activity in the markets so that there is enough speculation to provide liquidity but not so much that prices become unmoored from supply and demand. Up until 2000, that worked. The controls are called position limits. If you're not a bona fide hedger, you can only participate in these markets enough to provide the hedgers liquidity. If you provide more liquidity than needed, you unmoor the markets.
- Two events in 2000 CFMA:
    - Enron loophole. Section 2H. At the request of Enron and *against* Greenspan and the PWG, they freed up these markets. This benefited the ICE (Inter-Continental Exchange). NYMEX still had position limits. Speculators flooded ICE. Amaranth was told by NYMEX that you're going to blow up, you can't buy everything you want.

    ➔ Senate PSI, June 2007, when NYMEX told Amaranth they had reached their limits, Amaranth went to ICE.

- CFMA got the OTC energy swap market going. The OTC swap market is completely unregulated. You can either go to ICE or you can go into the private bilateral market. Before 2000, the OTC swap market was technically an illegal market until CFMA made it legal. There were no energy swaps or ag swaps prior to the CFMA.
- Goldman exemption. Goldman went to CFTC in 1991 and said if you're a bona fide hedger, you're not subject to the limits. We are a bona fide hedger because we're selling these swaps, so we should be allowed to hedge in the physical market. The Division granted them an exemption in a highly opaque fashion. Many of these investment banks… It didn't become public until June 2008.

➔ House Energy Committee had a chart showing that in 2000, 70% of market was commercial hedgers, 30% it was speculators. By 2008, 70% were speculators. Hearing June 23, 2008.

- May 2008: the ICE loophole was shut in the sense that the Congress gave the CFTC on a case-by-case basis to look at unregulated exchanges. CFTC has now re-regulated, after Gensler became head of CFTC.

- Both House and Senate reg reform bills give the CFTC the power to set position limits for all markets, whether regulated or unregulated. Summer 2008 both Houses had passed something that almost successfully did the same thing. That's one of the reasons the price of oil collapsed for six months; but then by early 2009 they hadn't done anything, so prices started to rise again.

  ➔ Gensler on July 7, 2009, announced that the CFTC was looking at this and would start regulating. European Commission has proposed regulations that would accomplish the same objectives. Every European country except UK due to their role in the market. G-20 statement.

  - House bills said Major Swap Participants would have to be regulated; they created an exemption for those involved for commercial, operational, or *book* hedging—which perpetuates the Goldman argument.
  - Early 2008, Goldman was saying, here's how to make money this year with stocks down. Pension funds were pouring money into the market. Lieberman was upset because heating prices were going through the roof. Lieberman proposed dramatic legislation: including pension funds shouldn't buy long.

  ➔ Dan Berkovitz, General Counsel at CFTC, had been in Senate PSI, which wrote the Red Wheat report in 2009.

- The CFMA doesn't allow for an ag swap; industry asks for exemption…
- If you don't get control on this thing… if gas were $4 in winter of 2009, it would have broken the back.
- July-August 2008:
  - Senate passed bill giving CFTC the authority to regulated; not enough votes to prevent cloture; House passes its bill; would have had to go to conference
  - Grassley/Biden pass bill to tax gains on normal income rather than capital gains.
  - CFTC announces investigation of these markets.

- CFTC imposed limitations on the ICE Futures Europe, a foreign exchange owned by ICE and regulated by the FSA which *doesn't* impose limits. That put a damper on crude oil speculation. Made prices crash.

Ties to crisis?

- A "major airline" when oil was at $147 locked in the prices at that range when GS was saying it would go to $200.
- Don't know ties to Lehman etc.
- [Credit default swap market: Can you similarly argue it got unhinged? Or is it the best measure of credit risk?]
- The interconnectedness on interest rate swaps, currency swaps, energy swaps, and commodities index swaps – is the reason these firms are TBTF. If this bank loses $X billion because it can't support its CDS obligations, what does this mean for the other obligations they have to other parties. For example, GS is the counterparty—what if it goes down?
  - ➔ See Robert Johnson on resolution authority.
- [Wendy: It would have real economic impact if the CDS on a company was explicitly tied to triggers, but otherwise?] I'm making the point about counterparty risk.
- Another way to look at it is—if you believe that the economy is paying a speculators' premium on basic commodities… $4.00 was feeding the speculators.

CFMA

- All futures transactions had to be traded on a regulated exchange; it was a felony to trade a regulated derivatives product outside of an exchange. Futures exchanges: Price transparency; regulation of intermediaries; licensing; self-regulated like the stock markets—mechanisms overseen not by SEC but by the CFTC.
- Somewhere in late 1980s the swap was invented; it is essentially a futures contract. 1989 the banks came to CFTC and said we don't want to do this new market in a regulatory fashion. 1989 Swaps Statement—if the swap is not traded electronically or on an exchange, and if each detail is negotiated and not standardized, we will not regulate it. 1992 Futures Trading Act (?). Exemption that told the CFTC had the power to exempt transactions if in public interest. April 1993 Wendy Gramm got two swap exemptions through the CFTC under the new statute.
- ISDA wrote standardized swaps—the ISDA Master Agreement. I'm involved in a case claiming the MA is inconsistent with statute and therefore illegal. People in the market say less than 10% or 15% are negotiated; the rest are done under ISDA MA, which are written by a committee and boilerplated and copyrighted. These are driving MAs for all types of swaps, including CDS.
- ➔ Greenberger August 5, 2009 testimony on behalf of Americans for Financial Reform before the CFTC on *Excessive Speculation: Position Limits and Exemptions*.
- ➔ Greenberger, *The Relationship of Unregulated Excessive Speculation to Oil Market Price Volatility*.
- ➔ Brooksley Born, CFTC Concept Release in 1998: These are "standardized contracts."

- [Counterfactual: What if Brooksley's position had been taken in 1999?] There would have been two things: There wouldn't have been the extent of synthetic CDOs because they would have been exchange traded. AIG FP never had to go to the adults—they had not capital requirements. My view is there wouldn't have been a financial crisis: Everyone would have had to put margin up. The regulators would have seen this huge build-up in risks. AIG would have had to post margin for every transaction; and variation margin. They didn't have the capital to support this. ISDA created a situation where you could enter into these obligations and you didn't have to post collateral. The end-users are now saying, how can you expect us to post margin. Swaps dealers don't to take any exams.
    - Every time a mortgage defaulted it wasn't a one-figure loss—people had synthetics that were betting on this.
- Winners vs losers. The winners had nobody to pay their winnings. The American taxpayer had to pay the winnings to prevent another Great Depression.
    - If AIG contracts had been cleared, the clearing agent would have required variation margin. It was also the investment banks.
- **➔Robert Litan: The Derivatives Dealers Club. April 2010**
- Enron was hedged through its own SPVs, which is illegal per se. It's a washed trade. You can manipulate the prices like that.
- I believe the CDS/synthetic CDO is what triggered the crisis… but Lehman had obligations all over the place. They had interest rate counterparties, exchange rate, commodities… [Kim: It was utterly because of derivatives exposures, agreed.]
- [Kim: Synthetic CDOs. We should get data on the extent of exposures and the extent of losses in the system. Who if anyone has tried to come up with that data?] Lehman Brothers… the examiner found that out. Lewis' book: synthetic created "fantasy" CDOs. Then you have CDS on the fantasy CDOs. Then you have naked CDS… Dinallo did a study on this—testified in February 2009. Before AIG there were the monolines sucked into this. He got called in February 2008 by FRBNY about MBIA. Dinallo didn't know what a CDS was. He says, this is insurance. In September, after AIG fails, he and Paterson on 9/22 say, from here on, we're going to treat real CDS as insurance. But naked CDS we can't do because CFMA banned states from regulating bucket shops etc. Without the anti-gaming preemption, you can't have any unregulated instrument. Other insurance commissioners said no. The insurance of an interest for which there is no risk is not insurance. That was out for six weeks, and Dinallo/Paterson pulled it back. Dinallo said for every CDS that insures real risk there are three naked CDS in the subprime securitization market.
- [Lehman?] The idea of transparency is not just that you have a good price but you have outside observers who will know what's going on. [Greenspan said these OTC derivatives markets performed well. What's the evidence that it didn't?] The evidence is the Lehman bankruptcy where they are asking creditors to come forward with prices and the receiver is saying you're vastly over-stating what you're owed.

    ➔ The Lehman receiver is angry.

    - The people who held CDS on Lehman, DTCC was able to net all of those out, instead of $100s of billions it was $6 billion. The industry said, we can figure this out. But look was the receiver is doing to Lehman counterparties. The credit crisis was caused because you had Citi, Wachovia, etc in trouble; you don't know what the counterparty is holding. Swaps market has none of regulation the equity securities market has.

      ➔ GAO 1994 report on derivatives.

      ➔ PWG 1999 report.
- [Even if we had been on an exchange or a clearinghouse, how do you know AIG would have been required to post enough variation margin?] You could be AAAA rated and you would have to post margin in an exchange because the transactions have to be cleared. Each exchange has a clearing facility. The clearing facility doesn't want to go bankrupt so they mark-to-market. ISDA wanted this market to grow like topsy, and the way it grew like topsy is the fiction that you didn't have to post margin. If it had been exchange-traded, there wouldn't have been any market. The nonbank counterparty loves the fact that they don't have to require collateral.
    - These counterparties are before Congress now saying, we want to continue the environment where we don't have to post collateral. There's a hidden cost to the nonbank end-user—they don't know what the spread is, and the banks/IBs like it that way.
    - [Goldman is screwed if AIG can't perform.] Geithner oversaw the 13 counterparties who got 100 cents on the dollar.
    - Goldman's in stronger shape than ever before. They want the same environment.
- The uncertainty about what this stuff is worth is the root of the problem.
- ISDA is like the mafia, you don't hit one another. If you sue other ISDA members, they'll kick you off the committee. There has been litigation since the crisis, but before the crisis there was not a rule that you would sue each other.

➔**Data sources: Go to the institutions. DTCC. Survey of exposures.**

- CFTC survey of energy swap market in 2008. The information wasn't very usable.
- I don't have any faith in BIS, ISDA, etc.
- AIG: $XXX billion goes in and goes out to the counterparties. Why did Goldman and these others get 100 cents on the dollar on their counterparty entitlements? We don't know if that was naked CDS?

  ➔ **Look at the AIG disclosure of its Goldman etc exposures for the Congressional hearing**. Are they naked/gambling or real hedges.
- Summer 2007: Meeting in Russia with Goldman. Goldman wanted to short the market because they were on the wrong side of the market.
- ISDA Master Agreement says we don't owe you anything and we could bet against you. You couldn't do that with a stock. The analogy would be advising your client to buy a stock while you're shorting.
- In the regulated markets, people are paying margin to Bear; Bear has an obligation to put those in segregated accounts. If I buy a wheat future from Bear—if the contract goes against me,

they'll say you need more. The reg reform bills now require if you put collateral up for a swap, that that will be in a segregated account as well. If the whole company goes down, who will make up that money? It should be a clearing facility.

- When AIG lost their AAA, instantly they owed $14 billion. It's not that there is no collateral required under ISDA.
- YRC Trucking… Pennsylvania is investigating.
- House bill created provision for CFTC/SEC to ban abusive swaps, but language was watered down.
- If the CDS had to be exchange traded… the crisis would have shrunk dramatically.
- This kept the housing market going up.