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### FCIC memo of staff interview with Michael Greenberger, University of Maryland Law School

Michael Greenberger

Brooksley Born

Chris Seefer

Dixie Noonan

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## MEMORANDUM FOR THE RECORD

Event: Michael Greenberger, Professor, University of Maryland School of Law; former Director, Division of Trading and Markets, Commodity Futures Trading Commission (1997-1999)

Type of Event: Interview

Date of Event: February 25, 2010

Team Leader: Chris Seefer

Location: FCIC, Large Conference Room

Participants – Non-Commission: Professor Michael Greenberger

Participants – Commission: Commissioner Brooksley Born, Chris Seefer, Dixie Noonan

MFR Prepared By: Dixie Noonan

Date of MFR: March 5, 2010

Summary of the Interview:

**This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.**

In January 2009, the UN “think group” regarding worldwide regulation of derivatives met. Prof. Greenberger debated two representatives from the United Kingdom who did not think that credit default swaps (CDS) were a problem. At the dinner that evening, George Soros spoke and said that CDS was to blame for the crisis.

The problem in Greece and Southern Europe is a currency swap problem, aggravated by CDS. Goldman Sachs is now actively marketing CDS on Greece (see Financial Times article dated February 24 or 25, 2010 re: this). Banks using currency swaps to provide short-term benefits with huge long term obligations to countries. According to Satyajit Das (see his FT article, “Greek window dressing puts derivatives’ role on full display,” Feb. 18, 2010), these swaps are preloaded so that the nonbank counterparty gets a good deal up front.

Gerry Corrigan testified to Parliament recently that these currency swaps were done in secret. Currency swaps were really *disguised loans*, where the bank paid the counterparty LIBOR + 3% for the first 2 years and then the counterparty pays the bank back later.

The City of Los Angeles has a problem now, because it swapped adjustable rates for fixed and now it’s on the losing end of that bet.

There has been exponential growth in the notional amount of over-the-counter (OTC) derivatives since Prof. Greenberger and Commissioner Born first started working on this in 1997 and 1998. The notional amount went from \$35 trillion to \$60 trillion at the time of the crisis. [?]

The International Swaps and Derivatives Association (ISDA) has 825 member banks. Now 5 U.S. banks are the largest swaps dealers.

Notional amount vs. amount at risk – “Notional” includes amounts that really aren’t at risk. In an interest rate swap, “notional amount” is the value of the underlying loan (i.e., the principal). For CDS, this comes together and notional amount is the same as the amount at risk.

Swaps were deregulated under the CFMA.

Dinallo (NY Insurance Superintendent) and NY Governor – 2008 – Directive – starting January 2009, CDS would be regulated as insurance. World clamored, and six weeks later they withdrew the directive, saying the Feds were going to do something.

HR4173 – preempts state insurance law.

National Council of Insurance Regulators is drafting a model insurance code re: CDS.

With CDS, you’re either hedging or betting.

Naked CDS – Geithner was pushing Dinallo, hoping he could solve AIG before it collapsed. Dinallo said he wouldn’t treat naked CDS as insurance because that’s either gaming or a “bucket shop.”

Dinallo did a study finding that there were three times as many naked CDS as those CDS used to hedge. \*This study was public and is cited in Greenberger’s article (of which he provided us electronic and hard copies during the interview).

Question – the \$180 billion in government money to AIG – was this money used to insure real losses, or bets?

Prof. Greenberger doesn’t necessarily oppose naked CDS, he thinks they should be transparent. It’s also a rating agency problem that Bear had a strong rating when its CDS spreads were growing. Also, you can just short a stock (e.g., AIG), without needing naked CDS.

Regarding the legislation currently being considered – Colin Peterson, the Chair of the House Agriculture Committee, included a legislative proposal to ban CDS. The Stupak rider to the cap & trade bill also included a ban on naked CDS. The current House bill does not have the ban, though.

Prior to the Commodity Futures Modernization Act of 2000 (CFMA), the general rule was that futures contracts couldn’t be traded except on a fully regulated, transparent exchange.

There are layers of self-regulatory bodies – FINRA/NFA and then the exchanges. SROs (self-regulating organizations) were established by the securities and futures laws: FINRA and the National Futures Association (NFA). By statute, government agencies delegated much oversight to these SROs. Behavior is dictated by federal law, and the SROs have to adopt rules to effectuate those laws. Securities exchanges and futures exchanges – called SROs – but implementing federal standards and laws through their rules. They have never gone beyond what’s required by law and the agencies. This structure was chosen for resource purposes.

Banks want self-regulation that is unsupervised.

Counterparty Risk Management Group – June 1999 Report – led by Gerry Corrigan – regarding Long Term Capital Management (LTCM). The report concludes that such a failure (i.e., like LTCM’s) will never happen again, that the industry will self-regulate.

There are no competency standards for swap dealers; no fiduciary standards.

The ISDA Master Agreement “is caveat emptor on steroids to the customer.” In some cases, the agreement says, “you understand we may be taking an opposite position on this.” (Prof. Greenberger gave an example of a case involving a glass manufacturer.) Prof. Greenberger made the point that the standardized agreements are never read.

In supporting regulation of derivatives, Prof. Greenberger doesn’t mean that we should babysit counterparties. But we need transparency.

Under the CFMA, a swap cannot be regulated by the federal government.

The derivatives market exceeds the equity market in value, yet we treat it incredibly differently. We would never agree to “just clearing” for securities.

“Eligible contract participants” – at least \$5 million. [?]

Commissioner Born: No attention was paid to protecting the U.S. economy in passing the CFMA. Even if you are of the belief that sophisticated investors should be able to protect their own interests (and thus consumer protections not needed). The exchange trading requirement of the Commodity Exchange Act (CEA) was never changed – just that that swaps were excluded (needed to be individually negotiated). The CFMA states that you cannot void a swap because it violates the CFMA.

LTCM failure involved interest rate, currency and equity swaps. Equity swaps are betting on the price of a stock – this was clearly illegal at the time.

Alternate Swaps Execution Facility – electronic facility or voice brokering – Michael Hirsch has the fully story on this.

Food and energy crisis – due to swaps that Goldman and Morgan Stanley sold that allowed people to bet on upward price swings of food, oil, etc.

The failure of Orange County, California, LTCM, Enron – all derived from derivatives other than credit default swaps.

Obama White Paper – June 2009<sup>1</sup> – says without exception that all standardized swaps should be cleared and exchange traded. On August 11, 2009, Geithner published a letter<sup>2</sup> (accompanying proposed legislation) saying yes, all should be cleared and exchange traded except currency swaps or if used to hedge risk. On August 17, 2009, CFTC Chair Gary Gensler wrote a letter<sup>3</sup> to Congress saying that these exemptions do away with the good parts of the proposed legislation. The current legislation includes the two exemptions suggested by Geithner. There is active debate right now whether HR 4173 is a step backwards from the CFMA.

YRC Trucking experience<sup>4</sup> – Pennsylvania has opened an investigation; other states are considering opening investigations. Dick Blumenthal wrote a letter to Goldman Sachs telling them if they didn't stop he would do something. Goldman Sachs asked for the Teamsters to waive all causes of action against it in exchange for its change in position.

Prof. Greenberger defines an “abusive swap” as swap intended to encourage bankruptcy or unemployment.

Commodity index swaps allow passive investors to bet on 25 different commodities.

Senator Levin has issued three big reports that are relevant to derivatives and excess speculation: (1) in 2006, on oil; (2) in 2007, on the Amaranth hedge fund collapse; and (3) in June 2009, on wheat. Prof. Greenberger testified on August 5, 2009 at the CFTC, and his testimony includes an executive summary of the wheat report. (Dan Berkovitz was responsible for all three reports; he is now counsel to Gensler at the CFTC.)

Commissioner Born: We really don't know what role other derivatives played in the collapse of Bear, Lehman, Merrill and the problems of JPMorgan and Goldman Sachs. Interest rate swaps were a much bigger part of their portfolios, and CDS was never more than 10%. We need to be very careful in focusing too exclusively on CDS. We know that CDS brought down AIG. We know that OTC derivatives and lack of transparency played a major role in the collapse of investment banks.

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<sup>1</sup> See [http://www.whitehouse.gov/the\\_press\\_office/President-Obama-to-Announce-Comprehensive-Plan-for-Regulatory-Reform/](http://www.whitehouse.gov/the_press_office/President-Obama-to-Announce-Comprehensive-Plan-for-Regulatory-Reform/).

<sup>2</sup> See <http://www.treas.gov/press/releases/tg261.htm>.

<sup>3</sup> See

[http://www.sifma.org/uploadedFiles/Government\\_Affairs/OTC/Gensler\\_to\\_Harkin\\_Chambliss\\_Aug\\_17\\_2009.pdf](http://www.sifma.org/uploadedFiles/Government_Affairs/OTC/Gensler_to_Harkin_Chambliss_Aug_17_2009.pdf).

<sup>4</sup> See separate MFR regarding our meeting with the Teamsters on February 23, 2010 concerning YRC Trucking.

Synthetic CDOs increased exponentially speculation on the mortgage market, which fueled the housing bubble and through enormous leverage and speculation, made the bursting of the housing bubble infinitely more painful. Bear, Lehman – said they were being pressured because speculators were using CDS to bring them down.

All OTC derivatives among all major players in financial markets and other institutions outside led to “too big to fail” problem. First, counterparty risk on OTC derivatives meant real problems when Lehman failed. Second, AIG couldn’t be allowed to fail, because of counterparty risk, and also because of correlation risk (i.e., many hedge funds were all betting the same way, which meant that everyone was going to suffer).

There was a New York Times article on February 11 concerning Lehman receiver in bankruptcy, regarding creditor claims for swaps.

Commissioner Born: We also need to look at the use of derivatives in creating bubbles in general. E.g., not just the housing bubble, but the energy bubble and the food bubble (e.g., riots in Indonesia; 184 relief organizations wrote to Obama in March [2009] re: starvation because of the price of rice). We should also consider looking at how accounting treatment for OTC derivatives led to their use to avoid disclosure, etc. (Greece is poster child.) The reason CDOs were such great buys for European banks was – if they got AIG to write CDS on CDOs, there was no capital requirement [for the CDO asset being held]. This was used to evade capital requirements.

There is also an ongoing IRS investigation concerning the use of swaps to sell to foreigners instead of equities. [?]

Off-balance sheet vehicles led to lack of investor confidence. \*Frank Partnoy wrote an article on SIVs that we should look at. We should also look at what pension funds are saying. The Council of Institutional Investors (CII) has come out with a position now.

Commissioner Born: Two issues – (1) What do we investigate; and (2) What do we put in the hearing (will be a small subset – focus on most visible and explainable aspects).

Interview AIG witnesses – did they know they were selling naked CDS? We also need to illuminate the problem with models (aka Taleb/The Black Swan). Why was risk so mispriced? Another question is how much are commercial mortgages involved in CDS? Is this a shoe still to drop? Because there is no transparency, we don’t know what’s still out there. We need to determine whether a big amount of questionable assets on the books of major institutions are derivative-related.

The banks (e.g., Citigroup, JPMorgan Chase) are required by federal regulators to hedge all swaps in order to be a derivatives dealer. Banks all went to AIG for the hedge. Query

whether the real scandal is that banks knew AIG wasn't hedging and weren't reserving appropriately.

We should talk to people at the banks buying the protection from AIG. What did they know and when did they know it?

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