Phil Angelides
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Commissioner

John W. Thompson
Commissioner

Peter J. Wallison
Commissioner

Wendy Edelberg
Executive Director

August 23, 2010

Via Email and Mail
Michael Greenberger
2757 Brandywine Street, NW
Washington, DC 20008
mgreenberger@law.umaryland.edu

Re: Financial Crisis Inquiry Commission Hearing on June 30, 2010

Dear Mr. Greenberger:

Thank you for testifying on June 30, 2010 in front of the Financial Crisis Inquiry Commission and agreeing to provide additional assistance. Toward that end, please provide written responses to the following additional questions and any additional information by September 7, 2010.[1]

1. During the hearing you expressed the view that derivatives were "side bets." You identified problems having to do with transparency, adequate capital, and fraud. You were asked whether there was anything wrong with these "side bets"—if they were transparent, backed by adequate capital and collateral, and devoid of fraud. Your reply included the remark that you would like to think about the matter further. Could you please assist the Commission by offering your more complete view on this question?

The FCIC appreciates your cooperation in providing the information requested. Please do not hesitate to contact Sarah Knaus at (202) 292-1394 or sknaus@fcic.gov if you have any questions or concerns.

Sincerely,

Wendy Edelberg
Executive Director, Financial Crisis Inquiry Commission

cc: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission

[1] The answers you provide to the questions in this letter are a continuation of your testimony and under the same oath you took before testifying on April 9, 2010. Further, please be advised that according to section 1001 of Title 18 of the United States Code, "Whoever, in any matter within the jurisdiction of any department or agency of the United States knowingly and willfully falsifies, conceals or covers up by any trick, scheme, or device a material fact, or makes any false, fictitious or fraudulent statements or representations, or makes or uses any false writing or document knowing the same to contain any false, fictitious or fraudulent statement or entry, shall be fined under this title or imprisoned not more than five years, or both."

UNIVERSITY OF MARYLAND
SCHOOL OF LAW

September 29, 2010

Wendy Edelberg, PhD
Executive Director
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW Suite 800
Washington, DC 20006

Re: Financial Crisis Inquiry Commission Hearing on June 30, 2010

Dear Dr. Edelberg:

I am writing in response to your August 23, 2010 letter calling upon me to follow up on my offer during my June 30, 2010 testimony to provide additional assistance to the Commission. Your letter posed the following question:

> "During the hearing you expressed the view that derivatives were 'side bets.' You identified problems having to do with transparency, adequate capital, and fraud. You were asked whether there was anything wrong with these 'side bets' – if they were transparent, backed by adequate capital and collateral, and devoid of fraud. Your reply included the remark that you would like to think more about the matter further. Could you please assist the Commission by offering your more complete view on this question?"[1]

This question pertains specifically to my analysis that the economic losses derived from subprime mortgage failures were made exponentially more damaging because three to four times of the monetary value of those mortgages were lost by failed bets on the success of those mortgages through synthetic collateralized debt obligations and naked credit default swaps. Because of a complete lack of regulation, those betting that the

[1] Letter from Dr. Wendy Edelberg, Executive Director, Financial Crisis Inquiry Commission, to Michael Greenberger, J.D., Law School Professor, University of Maryland School of Law (August 23, 2010).

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mortgages would succeed did not have the capital to pay off the obligations and the winning betters were made whole by U.S. taxpayer bailouts. Indeed, naked credit default swaps— bets by speculators that those with mortgage debt would default, but who had no underlying economic risk from the subprime market— were viewed by investors as "the cheapest, most effective way to bet against the entire housing market[.]"[2]

The question now posed by your letter is whether there is any harm in such bets if the betters are adequately capitalized so that the American taxpayer will not be called upon to be the casino lender of last resort. As demonstrated below, substantial harm to the economy would continue even with adequately capitalized and non-fraudulent multi-trillion dollar "side bets."

I. Moral Hazard

For centuries, it has been the fact that one cannot insure against someone else's risk. Insurance of that kind creates so-called "moral hazard," or the creation of perverse and nonproductive incentives to take actions that will lead to the triggering of the insurance guarantee. Naked CDS are the kind of insurance that long ago led to the creation of this insurance bar, because they were deemed a serious moral hazard. In 1746, Parliament passed the Marine Insurance Act, requiring anyone seeking to collect on an insurance contract to have an interest in the continued existence of the insured property. The purpose was to ban any bets on whether or not calamity would befall someone else's property. These naked insurance contracts would not only let the buyer place a bet, but they also gave the buyer an incentive to trigger the calamity.[3] Thus was born the insured-interest doctrine, which has been a fundamental part of insurance law in both England and the United States ever since.[4]

Naked CDS (or synthetic CDOs) encourage a "moral hazard" whereby market participants who are betting on failure have perverse incentives to take political and economic actions to ensure that instruments, companies, or governments covered by the naked CDS will fail.[5] For example, naked CDS provide a method to "short" the mortgage

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[2] *The Bet That Blew Up Wall Street: Steve Kroft On Credit Default Swaps And Their Central Role In The Unfolding Economic Crisis*, CBSNEWS.COM, August 30, 2009, *available at* http://www.cbsnews.com/stories/2008/10/26/60minutes/main4546199.shtml?tag=contentMain;contentBody (last visited on Sept. 19, 2010).

[3] Kimbal-Stanley, Arthur, *Dissecting A Strange Financial Creature*, THE PROVIDENCE J., April 7, 2008 ("Insurance contracts used to protect against the loss of property owned by the person buying the policy helped the buyer eliminate the consequences of calamity. Insurance contracts used to bet on whether or not calamity would befall someone else's property not only let the buyer place a bet, it gave the buyer incentive to make that calamity occur, to destroy the insured property he did not own, to sink the other guy's ship, in order to collect on an insurance contract.").

[4] *Id*.

[5] *The Role of Financial Derivatives in the Current Financial Crisis: Hearing before the Sen. Agric. Comm.,* 110th Cong. 3 (Oct. 14, 2008) (opening statement of Eric Dinallo, Superintendant, New York State Insurance Dept., stating that "[w]e engaged in the ultimate moral hazard…no one owned the downside of their underwriting decisions, because the banks passed it to Wall Street …; then investors bought it in the form of CDOs; and then they took out CDSs. And nowhere in that chain did anyone say, you must own that risk.").

lending market, which allows speculators to place the perfectly logical bet for little consideration (i.e., the relatively small premium) that those who could not afford mortgages would not pay them off. Holders of those bets formed a strong political constituency against the "rescue" of subprime borrowers that would have adjusted mortgages to keep homeowners from defaulting. The most illustrative example is the unsuccessful effort of the Helping Families Save Their Homes Act,[6] which would have allowed bankruptcy judges to adjust mortgages on primary residences and encourage banks to renegotiate mortgages with 8.1 million homeowners facing foreclosure.[7] Upon a surprising last minute shift of Democratic votes caused by intense lobbying from financial industries, Senator Richard Durbin, Deputy Majority leader and sponsor of the above provision, said "[t]he banks […] are still the most powerful lobby on Capitol Hill. And they frankly own the place."[8] On May 20, 2009, President Obama signed the Bill into law without the above provision. Obviously, those who had trillions of dollars of "side bets" that depended on defaulting subprime mortgages did not want to see mortgage rescues that would prevent defaults.

Another recent example of the "moral hazard" is the transactions of one of the largest U.S. financial services firms concerning the potential failure of one of the nation's largest freight companies, YRC Trucking. In an attempt to avoid bankruptcy and the loss of 30,000 jobs, YRC Trucking sought to restructure and convert $500 million of debt to equity.[9] Shortly before the deadline for conversion of December, 23, 2009, International Brotherhood of Teamsters (IBT), representing the YRC workers, discovered that the U.S. financial services firm in question arranged an intricate scheme to sell investors a package of YRC bonds with YRC CDS that would pay off upon the bankruptcy of YRC.[10] In fact, the financial services firm urged bondholders to vote against restructuring so that YRC would go into bankruptcy and trigger collections on the swaps.[11] YRC's restructuring succeeded, but only after the IBT launched a massive campaign in which IBT informed federal and state regulators nationwide that this investment strategy was "…encouraging investors to torpedo YRC's restructuring"[12] and "…trying to profit from a failure of the largest U.S. trucker by sales" [13] at the very time governmental policy was

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[6] Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong., *available at http://thomas.loc.gov/cgi-bin/bdquery/z?d111:H.R.1106*.

[7] *See* Official Website of Senator Dick Durbin, *Durbin Introduces Bill to Stem Record Foreclosures*, Jan. 6, 2009, *available at* http://durbin.senate.gov/showRelease.cfm?releaseId=306368 (last visited on Sept. 11, 2010).

[8] *See* Bill Moyers' Journal, PBS.ORG, May 8, 2010, *available at* http://www.pbs.org/moyers/journal/05082009/profile.html (last visited Sept. 11, 2010).

[9] Pierre Paulden and John Detrixhe, *Goldman Sachs Helps YRC Avert Bankruptcy following Hoffa's Plea,* BLOOMBERG.COM, Jan. 1, 2010, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=akW2fq12ZKOA (last visited on Sept. 11, 2010).

[10] *Id.*

[11] Duncan Wood and Christopher Whittall, *Goldman Halted Market-Making on YRC After Empty Creditor Claim*, RISK.NET, Feb. 1, 2010, *available at* http://www.risk.net/risk-magazine/news/1589502/goldman-halted-market-yrc-creditor-claim (last visited on Sept. 11, 2010).

[12] *Id.*

[13] Paulden and Detrixhe, *Goldman Sachs Helps YRC Avert Bankruptcy following Hoffa's Plea,* at 1.

enforced trying to save the dwindling U.S. manufacturing base as a recovery strategy from the Great Recession.

Yet another example of this "moral hazard" is the European sovereign debt crisis of 2010. During the crisis, it was revealed that a major U.S. financial services firm developed instruments that allowed the Greek government to borrow billions of Euros without appearing to add to the nation's debt.[14] While arranging these instruments, a U.S. financial services firm created an index that enabled market players to bet on whether Greece would default.[15] In February of 2010, a buyer of a CDS contract on five-year Greek bonds could receive €10 million in the case of default; however the price for the coverage was a mere €394,000 per year leaving the buyer of the CDS to recoup five times their original investment.[16] While helping the Greek government to incur more and more debt, the U.S. CDS originator stood to profit from the country's economic collapse. As the demand for credit default swaps increased, so did the cost of insuring Greek debt.[17] Investors began to shun Greek bonds, making it harder for the country to borrow, leaving Greece once again to seek the financial services firm's counsel about how to borrow more.[18] As a result the European Union was compelled to develop a huge bailout fund to rescue Greece and other EU countries experiencing similar difficulties in the credit markets.

II. Diversion of Funds from Investments Fostering Economic Growth to Gambling

Naked credit default swaps provide a perverse incentive to market participants to use financial resources for a casino-like activity that does not support the real economy. Rather than investing in or providing credit to real business endeavors that create jobs and increase the nation's gross domestic product, naked CDS transactions transform investors into gamblers. We are not talking about harmless and relatively trivial side bets of the kind that take place in poker games. At its height the CDS market was valued at

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[14] Louise Story, Landon Thomas Jr. and Nelson D. Schwartz, *Wall St. Helped to Mask Debt Fueling Europe's Crisis*, N.Y. TIMES, Feb. 13, 2010, *available at* http://www.nytimes.com/2010/02/14/business/global/14debt.html (last visited on Sept. 11, 2010).

[15] *See, Banks Bet Greece Defaults on Debt They Helped Hide,* N.Y. TIMES, Feb. 25, 2010, *available at* http://dealbook.blogs.nytimes.com/2010/02/25/banks-bet-greece-defaults-on-debt-they-helped-hide/ (last visited on Sept. 11, 2010); *See also* Allan Sloan, *Wall Street's role in Greek crisis should be no surprise,* WASH. POST, March, 10, 2010 (stating that "[w]hile helping Greece raise money (or obscure its debt, if that's the assignment), Goldman and other Street players happily went about creating credit default swaps [that] would […] pay off if Greece were to default. How much of this stuff do the Street people own? Where is it? What kind of securities has it been pushed into? No one knows. The one thing you can bet on, though, is that unraveling it all is going to be horribly complicated. Why? Because for Wall Street, complexity equals profitability.").

[16] Wolfgang Münchau, *Time to Outlaw Naked Credit Default Swaps*, FINANCIAL TIMES, Feb. 28, 2010, *available at* http://www.ft.com/cms/s/0/7b56f5b2-24a3-11df-8be0-00144feab49a.html (last visited on Sept. 11, 2010).

[17] *Banks Bet Greece Defaults on Debt They Helped Hide,* N.Y. TIMES, Feb. 25, 2010, *available at* http://dealbook.blogs.nytimes.com/2010/02/25/banks-bet-greece-defaults-on-debt-they-helped-hide/ (last visited on Sept. 11, 2010).

[18] *Id.*

approximately $65 trillion notional.[19] I doubt that elected officials and policy makers would be able to stand before the U.S. public and announce that they endorse a gambling environment supported by multi-trillions of dollars when such money does not flow into the real economy. After all, that would be the true and principal objective of this market even if it was properly capitalized.

Sincerely,

Michael Greenberger, J.D.
Law School Professor
University of Maryland School of Law

CC: Phil Angelides, Chairman, Financial Crisis Inquiry Commission
Bill Thomas, Vice Chairman, Financial Crisis Inquiry Commission

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[19] *See* Bank for International Settlements, BIS Quarterly Review (September, 2008), *available at* http://www.bis.org/publ/qtrpdf/r_qa0809.pdf#page=108 (last visited on Sept. 11, 2010).