Banking on Failure

Speculators' Use of Credit Default Swaps to Bet on Others' Misfortune Is Unseemly, Dangerous

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I. Introduction

Betting on the misfortune of others has an unsettling quality to it. It just feels wrong. Under our current financial regulatory regime, speculators freely gamble on businesses failing and countries defaulting. In addition to its unseemliness, betting on others' failure poses a grave risk to our financial system. Because these transactions are not transparent and are poorly regulated, we have little idea who is betting against whom or to what extent. This creates uncertainty in the market and proliferates risk. Additionally, betting on others' failure fundamentally changes the nature and purpose of financial markets. In theory, markets are supposed to allocate capital efficiently, benefiting individuals, businesses, and society as a whole. Banking on failure skews incentives such that investors profit when others fail.

In *Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps*,[1] Levy Institute scholars Marshall Auerback and L. Randall Wray examine how financial speculators gamble on others' failure using credit default swaps (CDS). CDS are the destabilizing instruments that facilitated the financial meltdown of 2008. At first glance, CDS look like insurance products. But because speculators can use them to profit from and even enable failure, CDS can also be gambling products.

The United States has been harmed by the practice of betting on failure in the past. More than 100 years ago, betting parlors started sprouting up across the country.[2] These "bucket shops" permitted speculators to gamble on securities' success or failure.[3] The parlors were called bucket shops because the bets were literally placed in buckets.[4]

Following a bank panic in 1907 that was caused by this type of unregulated speculation, the most prominent bankers in the country, led by "the nation's de facto central banker" J.P. Morgan (the individual, not the company), engaged in emergency stabilization efforts.[5] Private action was necessary because the Federal Reserve did not yet exist.[6] Two years later, states started passing anti-bucket shop laws, outlawing this destructive gambling

[1] Marshall Auerback and L. Randall Wray, *Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps*, The Levy Economics Institute of Bard College Policy Note (2009).
[2] *Hearing to Review the Role of Credit Derivatives in the U.S. Economy Before the House Committee on Agriculture*, 110th Cong. 79-83 (2008) (testimony of Eric Dinallo, Insurance Superintendent for New York State).
[3] *Id*.
[4] *Id*.
[5] *Id.*; Brendan Sapien, *Financial Weapons of Mass Destruction: From Bucket Shops To Credit Default Swaps*, 19 S. Cal. Interdisc. L.J. 411 (2010).
[6] The Federal Reserve System was created primarily in response to the 1907 bank panic. *Born of a Panic: Forming the* Fed *System*, The Region, The Federal Reserve Bank of Minneapolis, Aug 1, 1988, *available at* http://bit.ly/25SKsc.

practice.[7] These laws persisted for almost 100 years, until the U.S. Congress preempted them in the Commodity Futures Modernization Act of 2000.[8] This gave Wall Street free rein to bet on others' misfortune. Ironically, J.P. Morgan (the company) is credited with creating the modern day CDS in 1994.[9] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 preserved federal preemption of the state laws.[10]

II. Credit Default Swaps in Action

A. How CDS work

CDS are similar to insurance for lenders against the possibility that borrowers will default on loans.[11] A buyer seeking protection against a borrower's default contracts with a seller who offers to reimburse the buyer if default occurs.[12] A bondholder who seeks to insure against loss typically contracts with an investment bank, whereby the bondholder makes periodic premium payments in exchange for the bank's guarantee to repay the bondholder in the event of default.[13]

B. Problems with CDS

There are five main problems with CDS.

- CDS subvert the purpose of insurance, which is to prevent loss. Instead, CDS provide speculators an opportunity to profit from a loan's failure — and therefore a motive to help cause its failure.
- CDS create systemic risk by magnifying potential losses stemming from defaulting loans.
- CDS create empty creditors who have little incentive to avoid debtor bankruptcies and possible incentive to facilitate them.

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[7] *Hearing to Review the Role of Credit Derivatives in the U.S. Economy Before the House Committee on Agriculture*, 110th Cong. 79-83 (2008) (testimony of Eric Dinallo, Insurance Superintendent for New York State).
[8] Ordinarily, states have the authority to regulate both insurance and gambling. But in many areas the federal government can preempt state regulation because of the Supremacy Clause in the U.S. Constitution. *See* Art. IV, Cl. 2, U.S. Constitution ("This Constitution, and the Laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the constitution or laws of any state to the contrary notwithstanding.").
[9] Matthew Phillips, *The Monster That Ate Wall Street,* The Daily Beast, Sept. 26, 2008, *available at* http://bit.ly/s41fO5.
[10] 15 U.S.C. § 78bb (2000), amended by *Dodd-Frank*, Pub. L. No 111-203, Title VII § 767 (2010).
[11] Marshall Auerback and L. Randall Wray, *Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps*, The Levy Economics Institute of Bard College Policy Note (2009).
[12] *Id.*
[13] *Id.*

- The CDS market is opaque and unregulated, and it is difficult to discern investors' true interests regarding distressed assets or the overall risk to the financial system created by outstanding swaps.
- It's not always clear when CDS must be paid because the system for determining when payments should occur is murky, unregulated, and replete with conflicts of interest.

1. Naked CDS Subvert Traditional Incentives Underlying Insurance.

CDS that are sold to parties who haven't lent money to the relevant borrowers are called "naked" CDS.[14] Although CDS are often thought of as insurance-like products, naked CDS can actually subvert the incentives that typically underlie insurance.[15]

True insurance requires that the buyer seeking protection have an interest in the underlying asset to be protected.[16] As a result, a relationship is fostered between the insurer and the insured vis-à-vis that interest,[17] and incentives are aligned properly: The insured party's interest is that the asset not fail. If the asset does fail, the most that insured parties can recover is the amount in which they were harmed.[18] For example, a homeowner who purchases fire insurance has no interest in his or her house catching fire. If it does catch fire, the homeowner will be reimbursed only in the amount of actual losses. The public policy rationale for requiring an insurable interest is to prevent the use of insurance for gambling or wagering such that people would have an incentive to destroy lives or property to receive insurance benefits.[19] Naked CDS flout this policy.

Because investors can purchase credit default "insurance" on an asset without owning the underlying asset, they do not need to suffer any actual loss to collect.[20] In fact, they have an interest in the failure of the underlying loans. Moreover, payments on the CDS won't repair any damage done by the failures because they don't go to the lending institutions. The payments only serve to enrich the holders of the CDS. This is the equivalent of betting on your neighbor's house catching fire—or rather, a multitude of houses catching fire 3,000 miles away.

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[14] *Hearing to Review the Role of Credit Derivatives in the U.S. Economy Before the House Committee on Agriculture*, 110th Cong. 79-83 (2008) (testimony of Eric Dinallo, Insurance Superintendent for New York State).
[15] *Id.*
[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] 44 Am. Jur. 2D *Insurance* § 934 (2011).
[20] *Hearing to Review the Role of Credit Derivatives in the U.S. Economy Before the House Committee on Agriculture*, 110th Cong. 79-83 (2008) (testimony of Eric Dinallo, Insurance Superintendent for New York State).

2. Naked CDS Create Systemic Risk.

Naked CDS also have the potential to magnify losses from a default. When multiple speculators can bet on the same underlying interest and it fails, then a swaps seller must pay all of the speculators. Because derivatives are not regulated as insurance, derivatives sellers do not have to maintain adequate margin, collateral to buffer potential losses, as insurance companies must.[21] If a swaps seller does not set aside enough margin to cover potential swaps payments, it could cause the seller to default. If the seller is significant enough, then its failure could undermine the entire financial system.[22]

This is what happened to AIG in 2008. Although largely an insurance company, its Financial Products Division was not regulated as part of the insurance business. The division sold CDS on mortgage-backed securities without maintaining adequate margin.[23] When the securities failed and investors sought payment on the CDS, AIG could not cover its losses. When AIG failed, the government provided a taxpayer-funded bailout to the firm.[24]

The monetary losses stemming from CDS payments can be systemically devastating, as potential payments to CDS investors can easily reach billions of dollars. Estimates are that the gross amount of CDS contracts worldwide peaked in 2007 at $58.2 trillion.[25] As of December 2010, estimates are that the amount stood at $29.9 trillion.[26] With such substantial potential losses, these products clearly pose a grave threat to financial stability.

Indeed, one reason the CDS market is so large is that CDS seem to serve both sides of the transaction. For the buyer seeking protection, the cost is negligible relative to the possible reward.[27] For the seller offering protection, the arrangement may look like free money if the seller assumes that the underlying debt that is being insured is stable.[28] For example, it may only cost an investor five cents to insure $100 of debt. To the CDS buyer, the five cent bet is worth the possible $100 payout. To the CDS seller, it looks like a free five cents — that is until he or she must pay under the contract.

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[21] *Financial Crisis Inquiry Commission Report*, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, created by Public Law 111-21, 50 (January 2011), *available at* http://1.usa.gov/fackc5.
[22] *Id*.
[23] *Id*.
[24] *Id*.
[25] *Id*.
[26] *Bank for International Settlements OTC derivatives market activity in the second half of 2010*, Monetary and Economic Department, May 2011, *available at* http://bit.ly/mem2mP.
[27] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* 126 (Pantheon Books 1st ed. 2010).
[28] *Id*.

L. Randall Wray considers the systemic dangers of CDS so real, he believes that "[n]o bank that is backstopped by government should be allowed to use credit default swaps."[29]

3. CDS Create the "Empty Creditor" Problem.

Creditors, by virtue of their bondholder status, cannot be fully naked. An "empty creditor" holds CDS in addition to his bonds such that he or she may have little or no financial exposure to a bankruptcy and therefore have weak incentives to cooperate with a restructuring plan to avoid bankruptcy.[30] The creditor can get his or her full investment back more quickly by collecting under the CDS contract than a bankruptcy proceeding.[31] Additionally, because CDS can render a creditor ambivalent about bankruptcy, the creditor has less incentive to do due diligence on the credit risk of a borrower before lending money.[32]

With enough credit "protection," a creditor may profit more from borrower failures than successes. Moreover, a creditor with misaligned incentives has the power to increase the likelihood of a borrower's default by sabotaging the borrower's rehabilitation efforts.[33] For example, the creditor could force the borrower to follow onerous terms of a debt contract, knowing that those terms are unmanageable.

4. The CDS Market is Opaque.

Another problem with CDS is a lack of transparency in the CDS market. Because the law does not currently mandate disclosure of CDS positions, the public cannot discern the extent to which investors are using CDS as naked bets on others' failure or as empty creditors. As a result, we may not know investors' true interests regarding distressed assets or the overall risk to the financial system created by outstanding swaps.

Consider the case of Six Flags. The amusement park operator was struggling with a large debt load in 2009 and its management reportedly tried to avoid filing for bankruptcy by

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[29] Email from L. Randall Wray, Senior Scholar at the Levy Economics Institute of Bard College and Director of the Center for Full Employment and Price Stability at the University of Missouri, Kansas City (November 01, 2011) (on file with author).
[30] Henry T.C. Hu, *'Empty Creditors' and the Crisis*, Wall Street Journal, April 10, 2009, *available at* http://on.wsj.com/uhcx6X.
[31] Daniel Gross, *The Rise of the 'Empty Creditor'*, The Daily Beast, April 20, 2009, *available at* http://bit.ly/rFfbnP.
[32] Marshall Auerback and L. Randall Wray, *Banks Running Wild: The Subversion of Insurance by "Life Settlements" and Credit Default Swaps*, The Levy Economics Institute of Bard College Policy Note (2009).
[33] Henry T.C. Hu, *'Empty Creditors' and the Crisis*, Wall Street Journal, April 10, 2009, *available at* http://on.wsj.com/uhcx6X.

striking a deal with its bondholders.[34] However, according to the *Washington Post*, one bondholder refused even to consider the deal, for reasons that were not clear.[35] It is possible that the recalcitrant bondholder believed that Six Flags' financial health would improve to the point that it would not need to succumb to bankruptcy and would pay its debts in full. But it's also possible that the bondholder held CDS worth at least the value of its investment, if not more, meaning it stood to profit more from Six Flags going bankrupt than remaining solvent. We may never know the bondholder's motivation. On June 13, 2009, after failing to restructure its debt obligations, Six Flags filed for bankruptcy.[36]

The current financial crisis in Greece illustrates that we do not know the overall risk to the financial system created by outstanding swaps. If banks have hedged their exposure as well as they claim, their potential net payments triggered by a Greek default could be as low as $3.7 billion.[37] However, if the banks have not hedged their exposure, their payments could be as high as $75 billion.[38] Unfortunately, we may not know the true amount banks will owe to CDS buyers and the impact on the financial system until default occurs and payments are triggered.

5. CDS are Susceptible to Ambiguous Payment Triggers.

A final problem with CDS is that there are no bright lines to determine when a CDS payment is triggered. The system for determining when payments should occur is murky, unregulated, and replete with conflicts of interest.

For speculators to cash in on their bets and receive CDS payments, there must be a "credit event."[39] Failure to pay when due is the most common credit event, however a "credit event" can also occur through bankruptcy, a change in interest rate, a change in principal amount, or postponement of interest or principal payment date.[40] But even within these occurrences, there is considerable legal debate over what constitutes an "event."

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[34] Tim Arango, *Six Flags in Negotiations to Stave Off Chapter 11*, The New York Times, March 13, 2009, *available at* http://nyti.ms/giDjW.
[35] Michael S. Rosenwald, *Plagued by Debt, Six Flags Faces Its Own Wild Ride*, The Washington Post, April 13, 2009, *available at* http://wapo.st/vpXoyP.
[36] Michael, J. de la Merced, *Six Flags Files for Bankruptcy*, New York Times Dealbook, June 13, 2009, *available at* http://nyti.ms/uKHOxC.
[37] Lisa Pollack, *How Gross and Net CDS Notionals Really Work*, Financial Times, October 27, 2011, *available at* http://on.ft.com/sTvRvW.
[38] *Id*.
[39] Nicole S. Frank, *Proposed Legislation to Regulate Credit Default Swaps and Other OTC Derivatives: Who Does Greater Market Transparency Benefit?*, Robins, Kaplan, Miller & Ciresi L.L.P., February 2010, *available at* http://bit.ly/tHFRDc.
[40] Satyajit Das, *Default Semantics — Credit Default Swaps and Greece,* Naked Capitalism, June 27, 2011 *available at* http://bit.ly/t8Mfyx.

Consider the current financial crisis in Greece. The country has experienced distress due to mounting government debt. European officials recently reached a tentative restructuring agreement. Under the agreement, Greece will undergo a strict austerity plan to regain solvency and Greece's creditors will receive a reduction in their interests. Whether this restructuring agreement constitutes a "credit event" will likely be contested.

According to the major credit rating agencies and the International Swaps and Derivatives Association (ISDA), if the restructuring of Greek debt is voluntary among all parties, it will not likely constitute an "event."[41] However, if Greece suffers a hard default, either a failure to pay on its debt or a forced restructuring similar to bankruptcy, it will likely constitute an "event."[42] If and when CDS holders request a determination as to whether a "credit event" has occurred, it will be made by the ISDA's Determinations Committee.[43] Members of the committee include some of the world's largest and most powerful banks and hedge funds, many of which likely have a vested interest in whether CDS payments are triggered.[44]

Many different interests are affected by this deal. First, European officials want the restructuring to be deemed voluntary so that CDS are not triggered. If they are triggered, banks that wrote the contracts could be rendered insolvent, sending severe financial shocks through the Eurozone and abroad. For the same reason, the institutions that wrote the swaps want the restructuring to be deemed voluntary. Next, bondholders—who will lose 50 percent of their payments from Greece under the deal—will want a "hard" default to be declared if they own CDS that would pay more than Greece's restructured debt payments. Finally, the speculators who gambled on Greece's downfall want the restructuring to be deemed a "hard" default so that their bets pay off.

According to Marshall Auerback, the "Greece fiasco shows yet again what pernicious instruments these credit default swaps represent."[45]

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[41] Ellen Kelleher, *Greek Rescue Plan Worries Hedge Funds*, Financial Times, August 7, 2011, *available at* http://on.ft.com/sJcZ10.
[42] Satyajit Das, *Default Semantics — Credit Default Swaps and Greece*, Naked Capitalism, June 27, 2011 *available at* http://bit.ly/t8Mfyx.
[43] Press Release and Q&A, *ISDA Updates Greek Sovereign Debt Q&A*, International Swaps and Derivatives Association, October 27, 2011 *available at* http://bit.ly/tI27rK.
[44] *Id*; *ISDA Determinations Committees*, International Swaps and Derivatives Association (effective July 30, 2011), *available at* http://bit.ly/ubVOYP.
[45] Email from Marshall Auerback, Fellow at Economists for Peace and Security and Research Associate at the Levy Economics Institute (October 31, 2011) (on file with author).

III. Policy Prescriptions

After the Commodity Futures Modernization Act of 2000 and prior to the adoption of Dodd-Frank, derivatives such as CDS were completely unregulated and traded in secret. Dodd-Frank will change this, requiring closer scrutiny of derivatives markets and derivatives market participants. However, regulators have not finished implementing the derivatives provisions yet, making their precise impact an open question.

Stricter regulation should be implemented to curb the excesses of these products. Derivatives law should be amended to prohibit investors from holding CDS in excess of their exposure to the underlying assets. This would end the naked CDS problem and substantially curtail the empty creditor problem.

Short of these proposals, federal preemption of state laws that regulate derivatives under insurance, gambling, or bucket shop laws should be eliminated so that states can set standards that are more stringent than federal standards. The federal law should be deemed a floor, not a ceiling, of public protections.

More than three years have passed since the 2008 financial meltdown and more than one year has passed since Dodd-Frank became law. Despite these two critical events, the problems that CDS create and that helped cause the meltdown still exist. Without further action to make these products less dangerous, they may soon cause great damage to the financial system again.