"Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments. And indeed 100 percent of the citizens…and I was wrong about that."

—Former President Bill Clinton (2010)

II. Unregulated Derivatives Trading Fueled the Lending Frenzy and Pushed the Financial System to the Brink of Collapse

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There is little dispute that inadequate regulation of derivatives was a primary cause of the 2008 financial crisis. In admissions of the sort not often heard in Washington, D.C., many of the policy makers who supported deregulating derivatives in the 1990s now acknowledge that they were wrong. They include former President Bill Clinton, former Federal Reserve Chairman Alan Greenspan, and, with more nuance, two former Treasury secretaries.

Derivatives issuers used their regulatory exemption to take enormous risks. Derivatives buyers, in turn, drew a false sense of security from the contracts they purchased, prompting them to take on excess risk.

This illusion of security spurred a lending binge that caused housing prices to soar to unsustainable levels. After the housing bubble burst, the inability of derivatives issuer American International Group to make good on its obligations threatened to cause a domino-effect of financial institution failures. This led the Congress to authorize hundreds of billions of dollars in bailouts for the financial sector. The combination of the financial crisis and a devastated housing market caused a prolonged recession.

"I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II."

—Assistant Secretary of Treasury Lawrence Summers to CFTC Chairperson Brooksley Born on Born's plan to consider increasing regulation of derivatives (1998)

The Federal Government Deregulated Financial Derivatives at the End of the Clinton Administration

Financial derivatives are contracts "that gain or lose value as some underlying rate, price, or other economic variable changes," according to a definition offered by the Congressional Research Service.[3] Although derivatives are commonly tied to commodities, securities, interest rates, or currency values, they can be based on almost anything, including stock prices, energy prices, or even the weather.[4] Derivatives have traditionally been used to manage risk.

A type of derivative called a swap was developed in the 1980s. Participants in swaps agreed to pay one or the other depending on the fluctuation of an underlying variable.[5] Swaps often performed the same economic function as traditional futures, in which a party agreed to buy a commodity or financial instrument on a specified date.[6]

A distinguishing characteristic of swaps was that they were traded on an informal "over-the-counter," or OTC, basis. This distinguished them from futures, which were traded on regulated exchanges and backed by centralized clearinghouses, as mandated by the Commodity Exchange Act, or CEA. Swaps consisted of privately negotiated deals between counterparties.[7] Unlike traders using regulated exchanges, the participants in over-the-counter trades relied on each other to make good on their deals.

The absence of transparency in over-the-counter trading allowed swaps dealers to command more favorable prices. Trading over the counter also enabled dealers to dodge the licensing and margin requirements imposed by regulated exchanges. But because swaps were so similar to futures, they were potentially in violation of the CEA's exchange-trading requirement. This uncertainty left open the possibility that a court would refuse to enforce a swap if a counterparty questioned its legality.[8] Consequently, swaps dealers sought an exemption to the exchange-trading requirement that would give them legal certainty.[9]

The Commodity Futures Trading Commission, or CFTC, in 1989 provided an exemption to the exchange-trading requirement for swaps that were individually negotiated and not marketed to the public. But doubt existed over whether the CFTC had permission under the CEA to offer this assurance. Congress then explicitly granted the CFTC such authority. In 1993, the CFTC stipulated that non-standardized swaps negotiated between two parties would be exempt.[10]

Still, questions remained over the legality of many over-the-counter swaps. By the mid-1990s, swaps were becoming increasingly standardized, largely due to master agreements provided by the International Swaps Dealers Association (now the International Swaps and Derivatives Association).[11]

"OTC derivatives were now so…standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange traded standardized futures contracts," University of Maryland law professor Michael Greenberger testified to the congressionally appointed Financial Crisis Inquiry Commission, or FCIC, in 2010.[12] Greenberger served as director of the CFTC's Division of Trading and Markets in the late 1990s, when questions over regulation of derivatives hung in the balance.

Such standardization raised the prospect that many contracts trading over-the-counter did not meet the terms of the CFTC-issued exemption from the exchange-trading requirement and, thus, could be disallowed.[13] Meanwhile, the value of over-the-counter trading of swaps and other derivatives tripled from 1994 to 1997, to more than $28.7 trillion.[14]

Instances of ostensibly sophisticated investors experiencing wholly unexpected losses in over-the-counter derivatives trades were on the rise in the 1990s.[15] Most famously, Orange County, California, lost $1.5 billion in derivative investments in 1994 and was forced to file for bankruptcy.

> "The sophisticated counterparties that use derivatives simply do not require the same protections…as those required by retail investors."
> *—President's Working Group on Financial Markets (1999)*

Merrill Lynch, which sold the derivatives to the county, eventually paid $400 million to settle claims that it provided deceptive information.[16] Several other large institutions suffered significant losses in derivatives during the 1990s. In many cases, they were able to recoup part of their losses in litigation against the firms that guided them in their investments.[17]

The rising volume of over-the-counter derivatives trades coupled with lingering doubts over their legality created political tension. CFTC Chairperson Brooksley Born favored increasing regulation. Industry, in contrast, sought a guarantee that over-the-counter derivatives trades would be excluded from regulation.

In early 1998, Born contemplated issuing a request for public comments on whether the regulatory system for financial derivatives should be altered. She received a telephone call from Lawrence Summers, then an assistant secretary of the Treasury. "I have 13 bankers in my office and they say if you go forward with this, you will cause the worst financial crisis since World War II," Summers reportedly said.[18]

Born proceeded, nonetheless. In May 1998, the CFTC issued a "concept release" seeking public comment on whether to alter its largely hands-off approach to the trading of financial derivatives. The release noted that the over-the-counter derivatives market had experienced "explosive growth" in recent years, with increasing reports of losses, many by investors who did not understand the risks that they were taking.[19]

"Accordingly," the release stated, "the Commission believes it is appropriate at this time to consider whether any modifications…are needed to enhance the fairness, financial integrity, and efficiency of this market."[20]

> "Diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."
>
> —*Federal Reserve Chairman Alan Greenspan (1999)*

Born's release was the opening volley in a highly public debate that she would lose in the halls of Washington, D.C., but ultimately win in the eyes of history. On the same day that the CFTC published its concept release, Greenspan, Treasury Secretary Robert Rubin and Securities and Exchange Commission Chairman Arthur Levitt Jr. issued a joint statement expressing "grave concerns about this action and its possible consequences."[21]

The three wrote: "We seriously question the scope of the CFTC's jurisdiction in this area and we are very concerned about reports that the CFTC's action may increase the legal uncertainties concerning certain types of OTC derivatives."[22] Greenspan, Rubin and Levitt began pushing for legislation that would impose a moratorium on the CFTC's permission merely to consider changing regulation of derivatives.[23]

The collapse of Long-Term Capital Management in September of that year strengthened Born's case. Long-Term was a hedge fund that had used just $2.2 billion of underlying capital to make $1.25 trillion of investments in derivatives.[24] Turmoil in Russia had roiled the market in ways that Long-Term could not withstand.

The potential cascading effects of Long-Term's impending losses prompted the New York Federal Reserve to broker a deal calling for a consortium of banks to bail out the fund.[25] The banks infused $3.6 billion in capital in exchange for 90 percent of Long-Term's stock to avert disaster.[26]

Born testified to the House banking committee that the episode "should serve as a wake-up call about the unknown risks in the over-the-counter derivatives market."[27] But lawmakers did not heed the alarm. Instead, they imposed a six-month moratorium on the CFTC's permission to work on derivatives regulation.[28]

Some even took reassurance from the Long-Term episode. Greenspan, for instance, said it confirmed his "spare tire" theory that "diversity within the financial sector provides insurance against a financial problem turning into economy-wide distress."[29]

Greenspan continued to champion deregulation of derivatives unabashedly. "By far the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said in a March 1999 speech. "The fact that the [over-the-counter] markets function quite effectively without the benefits of [CFTC regulation] provides a strong argument for development of a less burdensome regime for exchange-traded financial derivatives."[30]

Born announced her plan to resign in January 1999 and left office in April.[31] In November of that year, the President's Working Group on Financial Markets—consisting of William J. Rainer (Born's replacement as chairman of the CFTC), Summers (who by then had become Treasury secretary), Greenspan and Levitt—issued a report calling for deregulation of the over-the-counter derivatives market to provide "legal certainty" that various activities were exempt from regulation under the CEA.[32]

"The sophisticated counterparties that use OTC derivatives simply do not require the same protections under the CEA as those required by retail investors," the report said.[33]

In December 2000, at the end of the Clinton administration, Congress passed the Commodity Futures Modernization Act, or CFMA, which almost fully deregulated OTC derivatives trades. The law exempted contract participants with at least $10 million in assets (signifying that they were sophisticated investors) from exchange trading requirements. The law also preempted state laws that might have otherwise prohibited trades that amounted to gambling.[34] President Clinton signed the bill.

Thus, the "multi-trillion dollar OTC derivatives market was removed from almost all pertinent federal and state enforcement to which trading markets had been subject since the New Deal," Greenberger wrote in 2011. "In effect, almost no law applied to this market" after passage of the CFMA.[35]

"Credit default swaps multiplied the risk of the failure of bad mortgages by orders of magnitude. And they ensured that when housing prices collapsed, the effects cascaded throughout the financial system."

—Securities and Exchange Commission Chairman Christopher Cox (2008)

Unchecked Risk in the Derivatives Market Pushed the Financial System to the Brink of Collapse

Over-the-counter derivatives trading grew dramatically in the years following passage of the CFMA. The notional value of such trades, according to the FCIC, increased from $95.2 trillion in 2000 to $672.2 trillion in 2008—a more than seven-fold increase.[36] By contrast, the entire world's assets in 2008 added up to only $178 trillion, according to the McKinsey Global Institute.[37]

It was possible for the value of derivatives trades to dwarf the entire world's wealth in part because multiple derivative positions could to be taken on the same underlying asset—even by investors who had no personal stake in the asset.

This characteristic of derivatives would prove particularly disastrous in the case of credit default swaps, a type of derivative that J.P. Morgan & Co. pioneered in the early 1990s and that insurance company American International Group Inc. began selling in about 1998.[38] Credit default swaps "insured" securities, such as collateralized debt obligations, or CDOs, which consisted of bundled securities, often including subprime mortgages.

Between 2003 and 2007, Wall Street created $700 billion in CDOs that included mortgage-backed securities as collateral.[39] Wall Street managers were hungry for mortgages to fashion into new CDOs, an endeavor for which they were handsomely paid. This appetite encouraged mortgage lenders to lower their underwriting standards because they believed they could easily unload newly issued mortgages to Wall Street's CDO underwriters. "In effect, the CDO became the engine that powered the mortgage supply chain," the FCIC wrote.[40]

But CDOs and credit default swaps were intertwined. While the FCIC likened CDOs to the "engine" of the mortgage supply chain, it said credit default swaps "fueled the mortgage securitization pipeline."[41] Investors in CDOs gleaned a sense of security by purchasing credit default swaps, which, they believed, would protect them in case their CDOs failed.

Greenberger shares this view. "Investors became unmoored from the essential risk underlying loans to non-credit worthy individuals" because credit default swaps provided a "seeming safety net to these risky investments," he wrote.[42]

The worldwide credit default swaps market, according to the FCIC, increased from $6.4 trillion at the end of 2004 to $58.2 trillion by the end of 2007.[43] As Greenberger has noted, that nearly equaled the annual gross domestic product for the entire world, which in 2007 was about $60 trillion.[44]

The danger posed by credit default swaps was compounded because (in a peculiarity differing from most derivatives), they paid off their entire value if the underlying asset failed, rather than simply paying according to the fluctuation of the asset's value.[45]

This danger was further exacerbated because multiple credit default swaps could be purchased on the same underlying asset. Besides using credit default swaps to insure assets they owned, investors could purchase them on assets owned by others. Such arrangements were called "naked credit default swaps" and were the equivalent of buying insurance on a neighbor's house in the hopes that it burns down.[46]

Naked credit default swaps marked an evolution in the purpose of derivatives from their traditional risk-management function to sheer gambling. When the financial crisis struck in 2008, three-to-four times as many naked credit default swaps were in circulation as credit default swaps held by investors who owned the underlying asset.[47] This amounted to many investors buying fire insurance on the same house.

"Credit default swaps multiplied the risk of the failure of bad mortgages by orders of magnitude. And they ensured that when housing prices collapsed, the effects cascaded throughout the financial system," Securities and Exchange Commission Chairman Christopher Cox testified after disaster struck in late 2008.[48]

> "By 2008, our regulatory framework with respect to derivatives was manifestly inadequate."
> *—Former Treasury Secretary Lawrence Summers (2010)*

But issuers of credit default swaps—particularly AIG—saw no such risk. They viewed the fees they received from credit default swaps as virtually free money because they did not think they would ever have to pay. AIG's models showed only a 0.15 percent chance—1 in 667—that it would ever have to make a single payment on a credit default swap because they believed the diversity of assets within CDOs protected against their failure.[49]

Because of this misplaced confidence and the absence of regulations to prevent firms from taking undue risks, credit default swap issuers did not maintain adequate reserves in case of disaster. AIG, for instance, took on $500 billion in credit default swap risks without being required to post any collateral, the FCIC reported.[50]

Issuers of credit default swaps were permitted to take such risks in part because credit default swaps were not regarded as insurance, even though that is essentially what they were.[51] If they were defined as insurance, they would have been regulated by the states. This means they would have been subject to capital reserve requirements and naked credit default swaps would have been illegal.[52]

"Under state insurance law, [naked credit default swaps] would be considered insuring someone else's risk, which is flatly banned," Greenberger wrote. To preserve their non-insurance status, credit default swap dealers advised bond issuers who purchased their products to refer to them as "swaps," not insurance.[53]

The fact that credit default swaps were not traded on regulated exchanges heightened the risk they posed. On regulated exchanges, a clearing facility guarantees each counterparty against the others.

Clearing facilities require the parties to post adequate collateral. No such protections applied to over-the-counter trades.[54]

> "Very strongly held views in the financial services industry in opposition to regulation were insurmountable."
>
> *—Former Treasury Secretary Robert Rubin, claiming in 2010 that he had favored greater regulation of derivatives in the 1990s*

Eventually, the housing bubble burst, causing widespread mortgage defaults and corresponding defaults of CDOs. Holders of credit default swaps that insured those CDOs demanded billions of dollars in collateral from their CDS issuers.

But AIG, the largest CDS provider, had nowhere near the capital to satisfy these demands. AIG's inability to make good on its obligations threatened to trigger a chain reaction of failures throughout the financial system that would cripple the economy.[55]

This threat prompted Congress to authorize hundreds of billions of dollars in bailouts to prevent a full economic meltdown. The U.S. Treasury and Federal Reserve eventually committed up to $182 billion to AIG.[56]

The Policy Makers Who Pushed for Derivatives Deregulation Now Admit They Were Wrong

Today, there is widespread consensus, even among those who pressed for a *laissez faire* approach in the 1990s, that creating a regulation-free haven for derivatives was a big mistake.

In 1998, Lawrence Summers warned CFTC Chairman Brooksley Born that any step toward regulating derivatives would cause the greatest economic disaster since World War II. He also co-signed the report claiming that parties in derivatives trades did not need oversight because they were "sophisticated."

He no longer holds these views. While stating that he could not have foreseen the changes in the derivatives market when he pressed for deregulation, he told the FCIC that "by 2008, our regulatory framework with respect to derivatives was manifestly inadequate."[57]

Robert Rubin, Summers' predecessor as Treasury secretary, co-signed the 1998 statement expressing "grave concerns" about Born's solicitation of opinions on whether to alter derivatives' regulation. He now sees this episode differently. He had agreed with Born's views at the time, he told the FCIC in 2010, but "very strongly held views in the financial services industry in opposition to regulation were insurmountable."[58]

In Rubin's defense, he did warn about the risks of unregulated derivatives in his 2003 memoir.[59] But when critical decisions were being made in the late 1990s, Rubin used his substantial influence to help block regulation, not to insist on it.[60]

Former Federal Reserve Chairman Greenspan, who was perhaps the most ardent advocate for deregulating derivatives, admitted at the onset of the financial crisis in 2008 that he had been "partially" wrong in his view that derivatives did not require more oversight.

"Credit default swaps, I think, have serious problems associated with them," Greenspan testified. More fundamentally, in repudiation of his longstanding faith in markets' ability to regulate themselves, Greenspan said, "those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself especially, are in a state of shocked disbelief."[61]

Former President Clinton expressed a *mea culpa* for allowing himself to be convinced that the regulation of derivatives was unnecessary because only sophisticated investors traded them. "Even if less than 1 percent of the total investment community is involved in derivative exchanges, so much money was involved that if they went bad, they could affect 100 percent of the investments, and indeed 100 percent of the citizens…and I was wrong about that," Clinton said.[62]

Recent Developments: Dodd-Frank Enacted Significant Reforms but Members of Congress Are Seeking to Reduce These Protections

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 instituted measures to make derivatives trading more transparent and less systemically risky. It called for most swaps to be traded on designated exchanges, cleared by designated organizations, and subject to capital and margin requirements.

Trading on exchanges provides for transparency, permitting buyers to shop for competitive prices. Clearing ensures that third-party organizations accept responsibility for contract obligations. The capital and margin requirements plug the regulatory hole that allowed AIG to take on risks that exceeded its resources. Dodd-Frank allowed highly customized swaps to be traded off of exchanges. But even in these cases, it imposed capital and margin requirements and insisted on public reporting.[63]

Industry has engaged in a concerted effort to weaken Dodd-Frank. At least nine bills were put forth in the 112th Congress that would have watered down its derivatives reforms. These proposals lost their momentum, at least temporarily, when the nation's largest bank, JPMorganChase, announced in May 2012 that it had lost at least $2.3 billion from bad derivatives bets.[64]

Only time will tell if the lessons from the disasters of unfettered derivatives trading will be sufficient to prevent Congress from acquiescing to industry's relentless demands for a free hand.