

# What's really burning down the financial house

**Derivatives are out of control. Time for adult supervision.**

By Mark Lange

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*San Francisco* - The most pressing business for the presidential transition team? Forget the customary interlude measuring the White House for drapes. Make it flights to Washington to meet with Treasury and Federal Reserve leadership, to begin restoring confidence in the financial system. This can't wait. It begins with the recognition that, behind all of the explanations and recriminations, what ultimately brought down the financial house were volatile investments known as "derivatives" – idiosyncratic and inscrutable securities "derived" from other securities, such as bundles of home mortgages. If we fail to regulate them, we will continue to invite the financial equivalent of arson.

The value of these financial abstractions has grown fivefold since 2002, to at least \$531 trillion today. That's nearly 10 times the total output of all of the goods and services *the entire world* produced last year.

Think of derivatives as computer-generated casino wagers. Upper-class slot machines, video games played by Wall Street's Masters of the Universe, they amount to bets placed on the future direction of interest rates, stocks, commodities – any asset or investment. Their aim is to cover losses, or reap gains from the bad bets of others.

In the case of housing, that meant shaky mortgages bundled up and priced based on guesstimated odds of being repaid, at exorbitant interest rates and dismal (or fictitious) credit ratings.

At best, derivatives can insulate against investment risk. But because they're entirely unregulated and trade on no public exchanges, their originators can deliberately hide their vulnerabilities. So anyone buying them risks burning down the house.

The most explosive derivatives? Credit default swaps – contracts sold to banks eager to insure themselves against default on the bad debt they knew they were issuing. These fake insurance policies sever the link between bank risk and borrower responsibility. Investment bankers lined up to bet on mortgage bankers' not being paid back – wagering teetering

piles of borrowed money on capital bases only 1/20<sup>th</sup> to 1/30<sup>th</sup> the size of the bets they'd placed.

Follow the dollars, and the housing boom wasn't a creature of Main Street. It was demand for these derivatives, including "securitized" mortgages, which led to loose lending and pumped up home prices. So when the banks' exposure (first at Bear Stearns, and fatally at Lehman Brothers) finally became obvious, their stocks cratered, and what meager capital coverage they had was burned up.

And there is still \$62 trillion in these bets on the balance sheets of banks and insurers. Wall Street's high finance has amounted to magical, money-for-nothing thinking. No wonder taxpayers are infuriated by the idea of paying the people who got us into this mess to get us out of it.

This was more than a matter of low rates, loose credit, and lax regulation, as former Federal Reserve Chairman Alan Greenspan almost alluded to last month. We got into this mess through a deliberate obstruction of regulation – a dogmatic dereliction of duty on the part of the Fed.

Arguing to strip the Commodity Futures Trading Commission of any regulatory authority over derivatives in 2000, then Chairman Greenspan asserted his confidence in "markets in which many of the larger risks are dramatically – I should say, fully – hedged." Regulators and members of Congress were cowed into compliance.

Mr. Greenspan still defends his obstruction of oversight for derivatives through four administrations – arguing that banks should self-regulate to protect their own reputations. He contends that stability in our financial markets should rely on banks' "counterparty surveillance" (Fed-speak for knowing whether somebody on the other end of a deal is good for the money). That would sound reassuring, except it's impossible with complex and unregulated derivatives such as credit default swaps.

Worse, it seems derivatives denial is still driving Treasury Secretary Paulson's apparent determination to spend public money to rid bank balance sheets of this toxic waste, rather than focusing on a fair and rational refinancing of the underlying home mortgages themselves.

The good news? Paulson's widely lambasted decision to let Lehman Brothers fail will look, in hindsight, like exactly the right kind of needed discipline – as painful as it is right now. Rather than suspending disbelief and denial, the way Japan did, it forced a reckoning.

But if Mr. Paulson and Fed Chairman Ben Bernanke really hope to secure a more positive legacy than Greenspan, and fight this financial fire, they'll support a 30-year fixed 6 percent refinancing option for the majority of subprime homeowners who are still keeping up with their payments, before adjustable rates escalate (and precipitate more defaults). And they'll force the early recognition of derivative losses, rather than allowing executives to mask them.

The only way to keep Wall Street from doing further damage is to demand regulation of the derivatives still circulating in the financial system – particularly the \$62 trillion in the market for credit default swaps. Whatever remains of investment banking should never again be allowed to borrow and bet \$25 for every dollar that's theirs. Hedge funds need basic oversight. Then, after putting derivatives on a regulated exchange, it will be time to rework our present Rubik's Cube of financial authorities into a more coherent framework.

While rumors of the end of capitalism as we know it are greatly exaggerated, the need to install a few regulatory smoke alarms is now excruciatingly obvious.

For the rest of us, if nothing else comes of this disaster, may it force us to refocus on savings over consumption. Not bigger valuations – better values.

What made this country were simple ideals – hard work, patience, thrift, and integrity – not the sophistry of financial abstractions that fire up Wall Street and burn Main Street. The sooner we get back to real business, the better.

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