Anatomy of a Meltdown

Figuring out what led to today’s economic mess could hold the best clues for moving forward—and averting the world’s next financial crisis.

By Patrick A. McGuire

SOME CALL IT A BLACK HOLE. OTHERS USE THE MORE SINISTER METAPHOR of “a dark market.” Robert Rhee, an associate professor at the University of Maryland School of Law who teaches corporate finance and corporate ethics says flatly “so much of the financial universe out there is unknown territory.”

His colleague, Law School Professor Michael Greenberger, the former federal regulator and now oft-quoted explainer of the economic meltdown for NPR and “60 Minutes,” speaks of “a shadow market.” This is a market, he says, that is understood by few, including top Wall Street insiders. Many of them, he says, had such little appreciation for the details of their risky practices that they not only caused unprecedented losses in the national and world economies, but wiped out tens of millions—in some cases hundreds of millions—of dollars from their own personal wealth.

“It’s crystal clear,” says Greenberger, who has testified on Capitol Hill about the financial meltdown almost a dozen times this year, “that except for some of the people doing the trading, at the highest levels the CEOs, the top officers absolutely did not understand what was happening.”
Exactly what was happening?
As policy makers in Washington sift through the debris of derailed derivatives and default swaps for answers to that question, Maryland School of Law faculty such as Greenberger and Rhee see a common cause for the meltdown.

“The biggest legal aspect to what’s happening now is the lack of regulation and the ineffectiveness of regulations,” says Rhee. “Aside from that, the larger causal mechanisms of this crisis remain outside of the law.”

An inciting incident that most financial experts now point to as an immediate cause of the current economic chaos was the passage in December 2000 of the Commodity Futures Modernization Act. The bill’s passage was principally arranged by Senator Phil Gramm, then chair of the Senate Banking Committee; it was sent to the floor of both Houses of Congress as a 262 page rider to an 11,000 page omnibus appropriations bill on the last day of a lame duck session of Congress on December 15, 2000. The bill was embraced by both sides of the aisle, passed by wide margins and was signed into law just before Christmas by President Bill Clinton.

In effect it deregulated the trading of derivatives and default swaps by telling the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC) that they had virtually no authority at all over them. And yet, according to Greenberger, there is more investment money today tied up in derivatives than in stocks and bonds.

“Nobody’s complaining that stock trading put us in this meltdown, or that regulated futures trading put us here,” says Greenberger, who served on the CFTC from 1997 to 1999. “It’s this dark-market derivative product, these private, bilateral transactions. Over the counter derivatives are today a $600 trillion notional value market. We [the CFTC] thought when it was $27 trillion in 1998 it ought to be regulated. We lost that battle.”

Derivatives are not new. Rhee says that derivatives have a Jekyll-Hyde duality. They can be used to hedge (mitigate) risk, but they can

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also be used to magnify risk-taking. As opposed to an investment in a commodity itself, a derivative is a bet on the future price of some other asset or index, such as stock or interest rates. The plainest instruments are futures and options. While investing in the standard commodity future remains mostly regulated, newer non-traditional forms such as credit default swaps are private transactions that are legally traded “off the books” and subject to almost no official scrutiny.

That the risk-hedging derivative suddenly became an economy-busting risk of its own derives from its use as a hedge against the failure of investments in sub-prime mortgage securities. Adding to the problem, according to a Maryland Law graduate who is now a prominent consultant to the financial industry in regulatory and governance services, were government policies that overinflated the sub-prime mortgage market and set the stage for its subsequent collapse.

“The rampage in derivatives was an outgrowth of the Fed’s ‘easy money’ policies,” says Ellyn Brown ’80, a current member of the board of directors of NYSE-Euronext, Inc., the publicly traded entity that owns and operates the New York Stock Exchange and the pan-European stock exchange. “The federal legislative and executive branches’ promotion of home ownership as an absolute good was ill thought-out and mostly uncoordinated,” she says. That, and what she sees as Congressional resistance to adequate oversight of Fannie Mae and Freddie Mac.

Brown, the Securities Commissioner for the State of Maryland from 1987 to 1992, cites economist Robert Samuelson, who “gives perhaps the most organic explanation of the genesis of today’s crisis: ‘Taking financial stability for granted, money managers, bankers, traders, government officials and ordinary investors did things that destroyed financial stability.’

As sub-prime mortgage loans were bundled together and sold as securities and collateralized debt obligations they, like most loans, were classified as senior, mezzanine and junior debt. As such they received credit ratings from organizations such as Moody’s and Standard and Poor’s.

“They got Triple A ratings for the most secure senior debt,” says Greenberger, “but that’s senior debt of sub-prime mortgages, given to people who have a high probability of not being able to pay the loans back. But many of the ‘brilliant minds’ ignored the underlying risk, and believed they got Triple A and Double A paper and they believed these were therefore conservative, solid investments and they sold them as that. People who bought them thought they were conservative, solid investments, not understanding it was a Triple A rating of junk.”

The frosting on this devil’s food cake was the credit default swaps. Those who granted the sub-prime mortgages, and those who bought them, took out what was essentially an insurance policy—so that if the mortgage holder defaulted, the insurance paid back their investment. Though these policies were often issued by insurance companies, such as AIG, they were not called insurance because then they would fall under state insurance regulations, which would have required capital reserves to support the guarantees. Labeled “credit default swaps,” they were deemed not subject to regulation and there were no capital requirements. The delusion of safety moved from the mortgagers to the insurers.

“They thought, ‘We’re getting premiums for this insurance for which we will never have to pay anything because there are no risks,” says Greenberger. ”It wasn’t just AIG. Everyone was issuing insurance, calling it swaps and not setting aside reserves and it blew a multi-trillion dollar hole in the economy. They never thought housing prices would go down. When housing prices went down the ‘insurance’ or swap got triggered. But unlike regulated insurance, they never had to set aside reserves to pay those policies. And you’re talking about a minimum of $25 trillion in insurance with no capital reserve.”

The insurance became the ultimate factor in self-delusion, says Rhee. “I think the insurance fed into the psychology and affected executive opinions as to how much risk they’d exposed themselves to.”

Once the supposed fail-safe factor of sub-prime mortgages—that housing prices will never fall—actually failed, no one was monitoring the domino effect of thousands of sub-prime mortgage foreclosures on other aspects of the economy. Investments thought to have been without risk now, in hindsight, seem obviously reckless.
"There has to be a relationship between risk and return," notes Rhee, a former New York and London investment banker with a Wharton MBA. "But proper risk taking is where Wall Street fell down."

Rhee worked as a vice president in the investment banking arm of Swiss Re in New York, as well as an investment banker with UBS Warburg and Deutschebanc Alex. Brown in Baltimore. He cites the reorganization of Wall Street firms as a factor that led to their short-sightedness in assessing risk.

"A while ago," he says, "Wall Street was made up of private companies that had their own capital. And it used to be you were using the firm's capital so it was preserved in a way that made sense. People had a greater interest in their stock in the company. The thought was, 'I can't blow up my own firm because a large part of my wealth is tied up in it.'"

But, he notes, many of those firms began going public or were merged with larger commercial banks with large balance sheets.

"Now it's shareholder's capital you're using," says Rhee. "The capital you can invest is whatever the executive committee or management will allow you to use in terms of your own trading activities. The risk-to-return relationship got skewed heavily. It encouraged excessive risk taking. That explains AIG. It was as if people were saying, 'What we're doing now is just printing money. The more policies we write, the more we sell this type of stuff. My year-end bonus will be X million.' Under those circumstances, people inside that group were probably getting caught up in this."

It was, he says, a classic house of cards and the incentives were perverse; even substantially employee-owned firms like Bears Stearns were not immune to the new psychology of risk taking.

"We were in a bubble. The bubble psychology is that you don't think you're the person without the seat when the music stops. It's always going to be someone else. I can't imagine that these bank executives were immune from that type of psychology.

"Don't forget some of these bank executives had hundreds of millions invested in their own firms, so if it blew up, it blew up their entire net worth. It leads me to think they knowingly engaged in excessive risk taking without knowing how excessive their risk taking really was. They did not think the risks would be magnified down every chain of every transaction."

How could supposedly savvy financiers so delude themselves?

Rhee says a former colleague on Wall Street who specializes in bond insurance, told him recently, "We didn't know X would lead to Y would lead to Z would lead to A would lead to B. We knew X was a problem. Or Y was a problem. But we didn't connect all the dots."

Wall Street traders understood the individual problems, says Rhee, "but there was no one sitting at the top saying, 'Okay, I see the trail of transactions and if something happens the trail of transactions will fall in a domino pattern like this.'"

In the meantime, a unified strategy for resolving the problem has remained elusive. Many want to concentrate on and punish villains. Banks decry talk of new, day-to-day regulatory monitoring and insist Wall Street be trusted to voluntarily clean up its mess. Reformers want tough new legislation enacting more restrictive regulations.

President Barack Obama said that the financial crisis has been a result of “gaps and weaknesses in the supervision and regulation of financial firms [that] presented challenges to our government's stability of our financial system.” In response, the Obama administration introduced a proposal in July 2009 to reform the regulation of financial markets with five key objectives: to promote robust supervision and regulation of financial firms; establish comprehensive supervision and regulation of financial markets; protect consumers and investors from financial abuse; improve tools for managing financial crises; and raise international regulatory standards and improve international cooperation.

Greenberger is concerned that President Barack Obama's objectives will be undercut by fierce lobbying by Wall Street and that Congress will only take half-steps toward re-regulation.

"Wall Street is simply calling for a private clearinghouse to be used by traders on a voluntary basis," he notes. "I say that's not enough. You have to have mandatory exchange trading for these derivatives so you have transparency. Not only transparency to the federal regulators, but to the public as a whole. It gives you an added set of regulatory tools that are being overlooked."
Meanwhile, those in the financial services industry caution against over-regulation.

"As a country we tend to legislate for the last problem and not for the next," says Christine Edwards ’83, former executive vice president and chief legal officer at Bank One Corporation and now a partner in Winston & Strawn’s corporate practice group who represents clients in the securities and banking industries on regulatory issues. "Trying to look forward to determine what is the next meltdown ready to happen is much more difficult."

The question of too much or too little regulation, she notes, or the type of legislation needed right now is less pressing than asking whether or not the right regulatory structure is in place to clearly inform and monitor key financial industry players and consumers.

"Do we need to address the duplication of effort between federal and state regulations?" she asks. "Or should we have a patchwork quilt of regulations between federal, state, local, certain law enforcement agencies and federal agencies? Because that’s what we have right now."

Brown supports the general idea of regulating for systemic risk “now that we’ve actually come face-to-face with the realities of our interlocked financial system.” However, she says, “We need to think not only about counterparty risk and all of the relationships that made Bear Stearns, Lehman Brothers, and Merrill Lynch so vulnerable, but also to the nature of global systemic risk, across institutions and markets worldwide.”

The entire issue of risk regulation, she says, "is perilous territory—the danger being that over-regulation will impede the innovation necessary to grow our economy." By definition, she says, innovation of any sort requires risk.

"It is one thing for government regulators to be concerned about, and move to regulate outrageous leverage ratios," says Brown. "It is quite another thing to ask a regulator to assess the risk inherent in a new financial product or service. Having been a regulator myself, I know very well that regulation is a defensive art form. Regulators aren’t out there in the market thinking up new products and services. The regulators’ mission is to prevent problems. Thus, the regulators’ inclination is to say ‘no’ rather than risk being wrong by embracing anything new and different.”