

The Oracle Blesses Derivatives, the Newest Game in the Casino

DERIVATIVES. Now there's a word that opens our sweat glands. Some of us last faced derivatives in calculus and ran for cover. But here we are again, grappling with a type of financial instrument that is supposedly so hard to understand that no one should attempt the feat, certainly not policy makers. Better we should leave it to the really smart people in the financial sector. Let the quantitative experts, the "quants," hold the high ground. Let the sophisticated traders create the derivatives and profit from them. And the rest of us? Duck and cover. (Or if you live in the Milwaukee area, put your hand on your wallet, because derivatives were what the school systems bought without knowing it.)

Sorry, but we're going to have to give it a try. It's the only way we can reclaim our citizenship (and our tax dollars) from the masters of high finance. For it is with derivatives that the toxic waste really got its start, back in the late 1980s and early 1990s. That was when the financiers finally got their hands on computers and figured out how to make complexity pay off.

So let's hang in there. I'm betting you and I can do this. We surely can't do worse than the policy makers who, back then, totally abdicated their regulatory responsibilities and put our entire economy at risk—despite the clearest warnings.

One clear warning came on May 19, 1994, when James L. Bothwell, on behalf of the General Accounting Office (the GAO, now the Government Accountability Office) testified before Congress. His words were chilling because they so directly warned of the colossal meltdown that hit us in 2008.

He began by defining derivatives as part innovation and part casino: "Among their benefits, derivatives provide end-users with opportunities to better manage financial risks associated with their business transactions, called hedging. They also provide opportunities to profit from anticipated movements in market prices or rates, called speculating."¹

This spanking new casino, Mr. Bothwell pointed out, was not just a few slots at a dusty Nevada gas station. No, by 1994, the derivatives casino had about \$12.1 trillion whizzing around the globe. And the business was heavily concentrated. As of December 1992, Bothwell said, "the top seven domestic bank OTC [unregulated "over the counter"] derivatives dealers accounted for more than 90 percent of total U.S. bank derivatives activity."² (The "top seven" were major investment banks and commercial banks. Within those institutions derivative groups are composed of traders, salespeople, and statisticians, who create, trade, and sell derivatives.)

Bothwell neglects to mention that the casino was already gushing profits (and bonuses) for the investment bankers who packaged, sold, and traded derivatives. I have yet to find a good estimate of the amount "earned" from that \$12.1 trillion, but let's assume it's at least half of 1 percent. That would bring the house cut from the casino to around \$60 billion—and that was back in 1994, when the dealers were just getting started.

So let's recap. We have some kind of derivative financial instruments, not yet described, that do things that add up to the trillions of dollars. We know there are relatively few players moving them around. We also know that these instruments are good when they hedge risk and not so good when they enhance speculation—that is, betting.

Why should we worry about speculation? Bothwell pointed out that because the trading and use of derivatives is so concentrated and the links between those who create, buy, and trade them are so tight, a "sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in

the markets and could also pose risks to others including federally insured banks and the financial system as a whole.³³

Translation? Bothwell was warning us that derivatives involved big, big trades and big, big bets on things like whether interest rates go up or down, or whether certain currencies change value. If a large derivatives trader lost big on its bets, the company might go bust. And if it defaulted, the cash this market needed to operate (liquidity) might dry up, causing others to fold up as well. Bothwell was also cautioning that the market for derivatives was so big that even federally insured banks (which had been loaning money to derivatives dealers) would suffer horribly if a major trader went belly-up. In short, he's describing the systemic risk of a market that is so large and incestuous that it would not easily withstand failure by a major player. He was warning that if a derivatives domino fell, it might knock down the banking and credit system dominoes as well.

Bothwell predicted that if one of the big derivative traders did collapse, the feds probably wouldn't intervene right away, since derivative trading was unregulated. But if insured banks got hit, the government would have to jump in—putting taxpayers on the hook:

Although the federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the federal government would be likely to intervene to keep the financial system functioning in cases of severe financial stress. While federal regulators have often been able to keep financial disruptions from becoming crises, in some cases intervention has and could result in a financial bailout paid for by taxpayers.⁴

Sound eerily familiar?

So what was Bothwell seeking with his alarming testimony back in 1994? He wanted a modicum of regulation. He didn't trust the industry's claim that it was policing itself. He wanted

new accounting standards that clarified the risks he knew the traders were hiding. He wanted oversight of over-the-counter trades. He wanted to be sure that the insurance industry, which was then getting into the derivatives act, didn't get burned. In short, he wanted a reasonably regulated casino.

But Bothwell, like virtually every policy maker, genuflected before the financial god of "innovation." Major investment banks, the big players on the Street, had surely warned him that if the government imposed regulations they didn't like, they would move the business to London or Paris. So on his knees Bothwell recites the catechism:

We believe that innovation and creativity are the strengths of the U.S. financial services industry and that these strengths should not be eroded or forced outside the United States by excessive regulation. . . . The issue is one of striking a proper balance between (1) allowing the U.S. financial services industry to grow and innovate and (2) protecting the safety and soundness of the nation's financial system.⁵

What a reasonable guy. Derivatives, he was saying, seem to be very useful and profitable and innovative, and lots of institutions have put a great deal of money into them. But they also seem to be risky. So as a prudent protector of the commonweal, the Congress should bring some order to this market of newfangled financial widgets. And this was in 1994!

But Bothwell's calls for caution were drowned out by none other than "the Oracle," Dr. Alan Greenspan, chairman of the Federal Reserve.⁶ Recall that by 1994, the economy, employment levels, and incomes were heading up. Greenspan, President Clinton, and later Clinton's treasury secretary, Robert Rubin, were more or less on the same page. Greenspan was a very smart and experienced economist who projected an aura of knowing every nook and cranny of the financial system. So when he said,

“Hands off!” people listened, especially members of Congress who definitely didn’t know much about these new derivatives. Of course Congress was also getting an earful from lobbyists for the big time Wall Street derivative players. The lobbyists even started a public relations campaign to expunge the word “derivatives” from the press: They preferred “securities.”⁷ Here’s how Greenspan put the case against derivative regulations in March 1995:

Markets function most efficiently when both parties to financial transactions are free to enter into transactions at their own discretion, unhampered by any perceived need to serve the interests of their counterparties. To date, losses in the financial markets have not led to broader systemic problems. Moreover, both dealers and their customers, somewhat shaken by the volatility of recent markets, are responding to these events by exercising greater caution. If discipline from incurring losses from mistakes were mitigated, vigilance would be relaxed, the market’s natural adaptive response would be blunted, and the value of decentralized market decisions as allocators of scarce capital resources would be reduced. I believe that we should start with the principle that parties to financial transactions are responsible for their own decisions and only use regulation to adjust the balance of responsibilities between the parties cautiously after the benefit has been clearly established.⁸

What is the Oracle really saying?

1. Markets by definition are efficient. They are by far the best way to determine utility and value and to allocate scarce resources.
2. If a product, financial or otherwise, sucks, it will disappear from the market as fast as the Edsel.

3. Since there is a very large and vibrant market for financial derivatives, by definition, they must be good—until the market decides they are not.
4. The market is the best regulator of derivatives, and regulators should stay away.
5. Besides, if you do try to regulate the derivative innovators, who obviously are much brighter than you'll ever be, they will outsmart you by finding new ways around your dumb rules. So don't waste your time, their time, or my time.

Nevertheless, Congress did consider mandating new accounting rules to accommodate derivatives. As it was, derivative transactions didn't even appear on the books. Banks and investment houses argued that it would be almost impossible to include derivatives in their accounting. They would be really, really hard to price because they were so volatile. They would make your company's books gyrate and give a foggy, inaccurate picture to investors. Wouldn't it be best to just keep that trillion dollars of risk and hedging off the books, out of sight and far away from both investors and regulators? Oracle Greenspan put it simply when testifying in 1995: "It would be a serious mistake to respond to these developments by singling out the derivative instruments for special regulatory treatment. Such a response would create artificial incentives to structure transactions on the basis of regulatory rules rather than on the economic characteristics of the transactions themselves."⁹

The Oracle prevailed.

It's downright amusing to watch the GAO and Greenspan wriggle their way out of even mentioning the distended profits generated by derivative trading. Greenspan, of course, believes that it is none of the government's business. The free market is supposed to create billionaires. They are the smart and deserving

risk takers. (There's a reason why he loves Ayn Rand, the author who stressed individualism and limited government in books such as *The Virtue of Selfishness*.) Derivative traders deserve what the market will bear. If they are overpaid the market will move funds away from them. There is no such thing as lavish profits. That's the miracle of the market.

Reality is somewhat less miraculous. We will soon discover there's an unfortunate connection between the get-rich derivatives industry and the current financial crash.

So what *are* these golden derivatives? Unfortunately the official definition uses the word we are trying to define: They are the broad class of financial instruments that *derive* their value based on the value or movement of other financial indicators, prices, or instruments.¹⁰ Clear as mud?

If you play in a fantasy sports league you should have an intuitive grasp of derivatives. A fantasy baseball team, for example, is composed of the statistics that are derived from real major league baseball players. You "own" a team much the same way someone owns a derivative. What gives it value is that you're involved in a bet with other fantasy baseball "owners" in your league to see which of your derivative teams accumulates the best statistics. In effect, you are speculating on the stats derived from real major-league players, but those players don't know they are playing on your team. You own only the derivative stats, not the real thing.

Let's consider a few financial examples. You could buy a derivative that is connected to whether interest rates rise or fall, or on which way exchange rates are going to move. Or instead of buying the underlying stocks that make up the Dow Jones Industrial Average you could buy a DJIA derivative that gains or loses value based only on how the Dow Jones Industrial Average moves. You could have a derivative that goes up or down with the price of oil, or just the price of oil in Japan or even the difference in oil prices between Texas and Norway. There are countless varieties of derivatives that allow you to swap income flows. A bank derivative group can design for you a derivative with another

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party so that you give up adjustable-rate income in exchange for fixed-rate income. Or you can give up interest income in dollars for interest income in euros. In short, because derivatives don't actually have to contain a "real" item (like a stock, a bond, or a barrel of oil) there is no limit to the kinds of derivatives your banker can (and does) create. What's more, as we now know, most of these transactions take place off the books of your firm and are unregulated. No wonder the GAO sounded the alarm.

But why would anyone want these devices? The answer is risk. Derivatives are created for people who want to get rid of risk by dumping it onto someone else, or who want to speculate by picking up the risk. When people buy derivatives they are accepting someone else's risk at a price that makes it worthwhile. Capitalist ideologues love to brag about how our system consists of millions of risk takers pushing the envelope of innovation. We're a country of swashbuckling entrepreneurs putting our life, limb, and hard-earned cash on the line for dreams that others didn't have the guts to believe in. Well, not quite. Our entrepreneurs also want to hedge every risk they can, in every way they can. And if they do take risks, they prefer, as Satyajit Das put it in *Traders, Guns and Money*, to "play with other people's money." The derivative traders—that is the ten or so big financial houses that run this show—cater to this endemic, risk-averse desire and earn a pretty penny doing so. Yes, entrepreneurs take risks but they're not stupid. If they can hedge their bets at a reasonable price, they will.

The classic example used repeatedly by the GAO in its discussion of derivatives is the industrious U.S. importer of an expensive piece of highly engineered German machinery due for delivery in a year. Unfortunately the price is in marks (these were pre-euro days)—let's say 10 million marks. You, the American importer, will have to pay for the machine in marks one year down the road when it is delivered. While the price in dollars may be a good one today, it might not be if the mark goes up in value compared to the dollar over the next year. This could be

quite a price hike, and it might just bust your business. So what do you do? In the 1990s you called your friendly Bankers Trust representative, and he'd design a derivative that would allow you to pay a slight premium for the right to have access to 10 million marks a year from now—at today's exchange rate. More likely your derivatives salesperson already spotted this problem and called you with such a product. You jump at the chance. Your banker makes a fee by selling you the instrument. He may also make a fee on selling the swap to another party that allows the banker to hedge your interest-rate risk. Or the bank may repackage the whole thing and sell it to someone else. You don't care. You've got your exchange rate for the 10 million marks locked in. That's the wholesome side of derivatives—protecting your firm's risk. Also, the collective shifting of risk through many such trades may be socially useful as well, since, when it works, risk is moving toward those who can better handle it.

But sometimes your friendly derivatives banker might try to sell you stuff you don't need, but that is very profitable to him and his bank. Satyajit Das's highly entertaining book on derivatives is framed by a set of such deals involving the managers of an Indonesian noodle firm. The noodle company's American banker noticed that the company might benefit if it hedged loans it had made in the Indonesian currency with a swap using dollar-denominated loans—a custom-made derivative the bank could create for the noodle company. So far so good, because the interest rate loan in the local currency was much higher than was the interest rate on dollar-denominated loans. After a while the banker reported that the derivative actually went up in value. Would they like to sell it and book the profit, which was several hundred thousand dollars? Of course. They sold, they profited, and then they bought from their banker a more complicated derivative that was virtually impossible to understand. It involved a bigger bet, which in turn led to another bet. The noodle makers had been lured into the casino and were playing with the high rollers—except they didn't know the game. One of

their biggest bets would only work if interest rates didn't fluctuate very much. Unfortunately, they did. And the noodlemakers soon lost over \$400 million!

In effect the banker was like a pusher. He got the noodlers hooked on making some fast money through currency speculation. At first they did (although it turned out the banker had made even more than they did on that deal, which they had no way of figuring out at the time). Meanwhile, every transaction generated more fees for the bank and bonus money for the banker. The more complex the instrument sold, the more fees embedded in it. A veteran banker friend of Satyarjit Das put it this way as he was training new derivative salespeople: "Sonny, give the guy a win first up. A nibble. He'll be hooked. Then, you reel him in real slow. That's how you land the big ones."¹¹

Das provides example after example of unscrupulous bank salespeople and traders who preyed upon companies, hooking them into complex products they didn't need or understand. The stories show how easy it is to slide from legitimate hedging activities into the casino. When the casino is working for you, you look like a genius. But sooner or later you're going to lose because you have no idea what you're doing. Meanwhile the derivative pros are making money from you on your way up and on your way down.

But let's be clear. This is not about good or bad people. The noodle makers waltzed into the fantasy-finance casino because they were as greedy as the bankers. Instead, our focus should be on the casino and the derivative gaming tables that can and did crash the economy.

Next comes a story that should be required reading for every public financial official and every firm that is trying to push financial instruments onto public agencies—starting in Wisconsin. It is the case of Orange County and Robert Citron, its treasurer, back in the late 1980s. Citron, who had no financial background, found his way onto the board of supervisors for Orange County, California, an affluent area north of San Diego. The county had considerable funds, and its internal investment rules were very

conservative. It wanted its money safely invested in short-term maturities that wouldn't go bust.

But Citron was a sitting duck for derivatives traders, who showed him how he could more or less conform to the county's rules, yet get much better returns. At the time, interest rates were dropping. The derivatives salespeople showered Citron with "securities" that provided better returns than any other county or state was getting on their cash. All he had to do was buy these complex derivatives, which supposedly were based upon very secure federal bonds and such. (You can hear the same refrain on the Wisconsin school board tapes.)

Citron heeded the siren's call, and for a while he looked like a hero. Orange County "earned" better returns than any other public entity around. To maintain his star status, all he had to do was continue to follow the lead of his derivative pushers. And push they did. They piled "innovative" instruments, one on top of the other until they were stacked like planes at JFK. They used his safe government investments as collateral to "leverage" bigger and bigger bets. In effect, Citron put up the county's money to borrow lots more, which was then bet on riskier and riskier plays. He also was the mark of all marks for the derivative houses, which saw the Orange County deal as a big bucks operation. As Das put it:

Every banker and trader prostrated themselves before him to get a share of the business. There was just so much money to be made. The dealers made money on the notes they sold to Orange County, they made money on the derivatives they used to hedge the structures, they made money on the money they lent Orange County so they could do the same all over again. It was a proverbial money tree.¹²

Best of all, the bankers risked none of their own money. They used Orange County funds on the cheap to make their plays. It

was as if Citron was staking the bankers to play alongside him at the casino tables. As Das writes, the bankers “got cheap money but took no risk as they made sure that all their bets were fully hedged. Who was paying for the party? It turned out to be Orange County taxpayers.”¹³

During their hot run, Citron was earning returns twice what other counties could achieve. He was *the* man of public finance. When another derivative dealer who didn't get in on the action questioned the soundness of some of his investments, Citron slapped him down: “You don't understand the type of investment strategies that we are using. I would suggest that you not seek doing business with Orange County.”¹⁴

But lady luck can leave you in a hurry when you're placing bigger and bigger bets that you really don't understand. By 1994 Citron had a mountain of chips on the table. He had \$7 billion in county funds, which the bankers had leveraged, with loans, up to about \$20 billion. Even Citron's bankers started to worry that they should go easy on this guy for fear they could jeopardize all the profits they were milking. But they didn't slow the game down. Things went smoothly as long as interest rates stayed low.

Citron looked in the mirror and saw one really smart dude. When asked why he thought interest rates would continue to stay low, he replied “I am one of the largest investors in America. I know these things.”¹⁵ (In fact he may not have been playing with a full deck. He later said that he had made some of his most brilliant investment decisions using a mail order astrologer's chart.¹⁶)

The casino party ended with a bang when Greenspan pushed interest rates up sharply in 1994. Citron lost all of his chips almost overnight. Not only did his portfolio show \$1.5 billion in losses, but the county had to come up with more cash in a hurry for collateral needed to secure their many leveraged positions. It was a mess. The county filed for bankruptcy on December 6, 1994. The poor suffered drastic cuts in services as at least sixteen hundred county workers lost their jobs.¹⁷

As it turned out, many other counties also had been lured into

the derivative casino by their profit-hungry bankers. Dozens of guardians of public-sector funds couldn't resist the promise of higher and higher returns, and many lost the public's money along the way. The dealers got their hands slapped and several had to make restitution of sorts. Still, the major derivative banks, brokerages, and investment houses walked away with vast sums. When it comes to profits and bonuses, what happens in the derivative casino, stays in the derivative casino.

Let's keep following the money. The case of Orange County, like that of the Indonesian noodle company, shows how easy it was for astute bankers to use opaque financial instruments to lure their marks into risky investments. These examples and many others like them (Procter & Gamble, Gibson Greeting Cards, etc.) also reveal the mismatch between the sophisticated derivative pusher and the marks who so obviously were in over their heads.

The collapse of Long-Term Capital Management, however, demonstrated that even the most sophisticated hedge fund managers could also lose at the casino and in doing so threaten the entire financial system. In fact, bigger and smarter meant even more danger. (We're still in the 1990s. You'd be right to wonder why we didn't learn more from these events.)

John Meriwether, the guru of derivatives traders, set up LTCM, which many heralded as the gold standard of hedge funds. By this point the term "hedge fund" had lost its original meaning. You did not put money into a hedge fund to hedge your bets, as was the case with the first such investment funds during the 1950s. Instead, you put money in these funds to play the casino, shoulder to shoulder with the hedge fund's creators—playing alongside the smart money. To play with Meriwether you had to be very rich: You couldn't join his hedge fund unless you anted up \$10 million. Here's what you got. For the privilege of playing with a master casino guru, Meriwether charged 2 percent of the money you gave him plus 25 percent of the winnings. By 1994, he had

gathered a \$1.5-billion stake from his investors. His 2 percent up front was a cool \$30 million.

Starting with a fat wad, Meriwether rounded up the best and the brightest traders, including a dozen or so Ph.D.s, and two of his former finance professors. They were certain they could bend the casino odds again and again. And they had all the cash they needed: Major investment banks loaned them billions, often without requiring any collateral. After a few years the value of their fund grew to about \$4.7 billion. They leveraged that into another \$125 billion with borrowed money. Then they used derivatives to place bets that totaled \$1.25 trillion. That's quite a pile of chips (more than a million piles with each pile containing a million chips!).

At first, Meriwether and company played it safe, looking for slight differences in prices among similar items in different markets. They knew the same items ought to end up at the same price sooner or later, so they bet on the cheaper one and sold their bet on the more expensive one until the prices matched up. That's called arbitrage.¹⁸ When you placed billions on such bets you could make real money. While 1994 was a terrible year for Wall Street as a whole, Meriwether made a 28 percent return on the fund's initial equity. Let's pause and do the math. Twenty-eight percent of \$1.5 billion comes to \$420 million—a nice return for the fund as whole. Meriwether and his partners took 25 percent, for a total of \$105 million. Not bad.

It got better. In 1995 they got lucky with interest-rate plays. The Kobe earthquake in Japan increased market volatility and, by chance, dramatically increased the value of certain options they had bet upon. That year they "earned" a 59 percent return. In 1996 they started winning bets with other nations, almost sure bets, because of close relationships they had developed with central banks overseas. That year they returned 44 percent on their capital. Just imagine how smart and lucky you would feel with returns of 28 percent, 59 percent, and 44 percent back to back to back.

Economic theory tells us that competition should have driven returns back toward the national average as more firms entered into this lucrative business. In fact by 1997, Meriwether's firm did start to feel the heat. It was becoming harder and harder to find those special bets at the casino, because many new hedge funds were crowding the table. As a result, in 1997 the fund's returns dropped to "only" 17 percent.

As they built up their wad of surplus capital, it became harder and harder to properly invest it. Frank Partnoy in *Infectious Greed* writes that in 1998 Meriwether and his partners "agreed that they would reduce the size of the fund by about \$3 billion, because of concern that they might not be able to find enough good investments. . . ."19 Capitalism was doing its thing. High profits had attracted more players, and the space to secure superprofits had narrowed.

But Long-Term Capital Management was sure they had the best talent. They also were sure they had prepared for the worst. They had placed a lot of bets on a whole bunch of different casino tables and they thought they had hedged themselves pretty well. They also figured that these tables were far enough apart so that there was no way that all their bets could turn against them at the same time. In technical terms, they thought their investments were not "correlated." As Partnoy put it, "They had believed their portfolios were sufficiently diversified to survive even if the ball on the roulette wheel landed on black several times in a row."²⁰

However, 1997-98 saw turmoil. Many hedge funds had placed bets in emerging markets in developing nations, expecting good things. Then Russia defaulted on its debts. Banks that were making big loans to hedge funds wanted more collateral. Hedge funds had to sell assets to come up with that collateral—which drove down asset prices. The rout was on. As Partnoy says, "all of LTCM's supposedly uncorrelated bets were going down, at the same time. The ball was landing on black, over and over again."²¹

Alan Greenspan and Clinton's treasury secretary Robert Rubin

feared a systemic meltdown if LTCM declared bankruptcy. They understood that complex derivatives linked LTCM to major banks and traders all over the globe. If LTCM went down, it could set off a domino effect leading to bank failures. Still, the Fed refused to bail the hedge fund out, fearing that this would create a moral hazard. Every hedge fund would gamble more recklessly if they knew that they too might be "too big to fail." Instead the Fed pressured a consortium of fourteen major banks that had lent to LTCM to put up \$3.6 billion to bail them out and take over the failed fund. The international meltdown was averted.

Having seen the best and brightest fail with derivatives, you would think that Greenspan and Rubin would have called for regulating the shadowy derivatives market. You would be wrong.

Unlike Alan Greenspan, Brooksley Born is not a household name. She should be. She had the chutzpah as head of the Commodities and Futures Trading Commission to call for regulating derivatives, in defiance of Greenspan and Rubin.

Ms. Born, a teacher's daughter whose father was the head of a public-welfare agency in San Francisco, had attended Stanford University in the late 1950s and early 1960s. It was a time when talented women had great difficulty finding meaningful careers. She had wanted to be a doctor, but her guidance counselor told her she should be a nurse. If she didn't want to do that, it showed she lacked compassion and she should switch away from the helping professions. Born became an English major. But once she learned how hard it would be to find a job that used her English degree she entered Stanford Law School.

In 1962, Born was one of 10 women in a class of 165. Some of the men weren't pleased: "At the beginning of my first year, one of the men in my class told me I was doing a terrible thing because I had taken the place of a man who had to go to Vietnam and might get killed. That was difficult to deal with. At the time males were drafted if they were unable to get a deferment."²²

Upon graduation she clerked for a liberal federal judge and then became an associate at Arnold and Porter in Washington, DC. She admired the firm because it had vigorously defended victims of McCarthyism during the 1950s. As a lawyer she developed an interest in international trade—which eventually included defending international clients in suits about derivatives—and in women’s issues. She taught one of the first “Women and Law” classes in the DC area and seemed to have a great deal of respect for unions and collective bargaining. (She also became involved in the litigation surrounding the Hunt brothers’ efforts to corner the silver market, made famous in the hilarious movie *Trading Places*.) Born was an ideal candidate for public service in the Clinton administration.

In 1995, the chair of the Commodities Futures Trading Commission opened up and Born got the nod. The position put her smack in the middle of the derivatives debate. Unlike so many congressional members and staff, she actually knew how they worked. It was a fortuitous appointment.

The last Reagan appointee to hold the job was Wendy Gramm, wife of Senator Phil Gramm, the Texas Republican. In her last act as chair, Gramm had granted an official regulatory exemption allowing the trading of derivatives in unregulated over-the-counter markets. In effect she cut the ribbon on the derivatives casino. As Born describes it, “The market was completely opaque. Neither the commission nor any other federal regulator knew what was going on in that market!”

Born was at the helm of the Commodities Futures Trading Commission when Long-Term Capital Management failed. As she said, it “had to be bailed out by a number of large OTC derivatives dealers because it had \$1.25 trillion worth of derivative contracts at the same time it had less than \$4 billion in capital to support them.” (In other words, it was on the hook for \$312.50 for every \$1 it actually had of its own.)

All Born’s training and experience warned her that this was “a nightmare waiting to happen,” as she put it in 2003. “I realized

there was a tremendous potential danger to the markets in the United States and to the international economy.” So she tiptoed oh so carefully toward oversight for derivatives, a question she believed was well within her purview. She recalled that “The commission came out with a concept release in the *Federal Register* asking for input from the industry and other interested people concerning the need for more oversight of the over-the-counter derivatives market.” In other words, she was ready to consider reversing Wendy Gramm’s exemption.

She might as well have threatened to nuke Wall Street. The response from the derivatives industry, from Fed chair Alan Greenspan, from Arthur Levitt, head of the Securities and Exchange Commission, and even from the kindly treasury secretary, Robert Rubin, was swift and harsh. According to the *New York Times*,

On April 21, 1998, senior federal financial regulators convened in a wood-paneled conference room at the Treasury to discuss Ms. Born’s proposal. Mr. Rubin and Mr. Greenspan implored her to reconsider, according to both Mr. Greenberger [a senior director of the CFTC] and Mr. Levitt.

Ms. Born pushed ahead. On June 5, 1998, Mr. Greenspan, Mr. Rubin and Mr. Levitt called on Congress to prevent Ms. Born from acting until more senior regulators developed their own recommendations. Mr. Levitt says he now regrets that decision. Mr. Greenspan and Mr. Rubin were “joined at the hip on this,” he said. “They were certainly very fiercely opposed to this and persuaded me that this would cause chaos. . . .”

Greenspan told Brooksley that she essentially didn’t know what she was doing and she’d cause a financial crisis,” said Michael Greenberger, who was a senior director at the commission. “Brooksley was this woman who was not playing tennis with these guys and not

having lunch with these guys. There was a little bit of the feeling that this woman was not of Wall Street.”²³

Then, to finally kill any effort to control OTC derivatives, Senator Phil Gramm successfully inserted an amendment into a 1999 appropriations bill that postponed all CFTC regulatory efforts for six months. There were no hearings, no discussions. A year later, Gramm attached a last-minute 232-page amendment to the omnibus appropriations bill called the “Commodities Futures Modernization Act.” He seemed to be the only member of Congress who understood it. On the Senate floor Gramm argued that the bill, which exempted derivatives from all regulations, would “protect financial institutions from overregulation” and “position our financial services industries to be world leaders into the new century.”²⁴ It passed and President Clinton signed it. The bill was viewed as a sop to Enron, which was deep into the derivatives business. Wendy Gramm went on Enron’s board and made a million or so. Brooksley Born departed from the government, retired from her law firm, and continued her work in support of women’s issues in the Washington, DC, area.

Before we so unceremoniously dismiss Greenspan’s love of all things private and derivative, we need to ask a critical question. Would the kind of regulatory reform Born had in mind have prevented the current financial meltdown?

Born wanted increased transparency—a kiss-and-tell policy that would have enabled all investors to figure out who had what kind of derivative relationships with whom. She also wanted to be sure traders and dealers were openly and honestly conducting their business, and that the books accurately reflected the assets and liabilities involved in these complex transactions. But she didn’t want to kill the derivatives market. “These instruments,” she said, “can be used to reduce economic risk, and they are certainly very valuable and useful economic instruments.”²⁵ She

just wanted to prevent them from creating “enormous risks”—as they had at Long-Term Capital Management, and soon would at Enron.

Buried within Greenspan’s ideological gibberish is a compelling practical argument: This kind of regulatory regime would not work even if it were desirable. He and many others believe that derivatives are so pliable that they would immediately be reconstructed to circumvent any rules we passed to regulate them. The evil genius of derivatives is that they can be packaged, repackaged, stripped, striped, sliced, and glued back together in an almost infinite number of sizes and shapes. It would be hard ever to make them entirely transparent. Even if we reined in derivatives in this country, it would be difficult to prevent some small country from becoming a new haven for derivative trading, because the payoff would be enormous: trillions of dollars of deals. So unless you could round up the entire world to regulate derivatives, they would probably find ways to scramble back into the shadows. It’s very hard to police financial relations (or betting) among consenting adults.

This argument has some merit. It seems likely that derivative traders would find a way to evade the mild regulatory approach suggested by the GAO and Born. The powerful derivatives-industry lobbyists would probably be able to secure plenty of caveats in any such regulations. “Protect Financial Innovation” would have been the fight song in Congress. It’s highly possible that Born’s efforts, however laudable, would have been far too accommodating and therefore ineffective.

Surely letting derivatives roam free was a recipe for disaster. But controlling them would require a great deal of political will. We’d have to see an awful lot of derivatives-derived havoc to generate that kind of will. It would take . . . a system meltdown. Like now.

Now that our biggest banks, largest insurance company, and largest mortgage agencies have been essentially nationalized, the time is ripe for extensive regulatory reform. But there are nagging

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questions that may not be so easily resolved. What if there is a fundamental underlying tendency in capitalism that leads toward asset inflation and booms, and then crashes? Can carefully crafted regulations really address such problems? We'll return to these themes in the concluding chapters. But now it's time to don our hazmat suits and take a closer look at Wall Street's toxic waste.