# The Rubin-Greenspan *Legacy*

*Now Paulson's ongoing nightmare.*

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Few Secretaries of the Treasury have encountered the firestorm of crises and events that have confronted U.S. Secretary of the Treasury Henry Paulson. The former CEO of Goldman Sachs certainly did not cause the financial crisis of 2008—at least not during his tenure at Treasury—but his actions and failure to act will leave a profound impression on the financial markets for decades to come. The nationalization of a good chunk of the U.S. banking industry and a vast cleanup still to be accomplished are Paulson's legacies to the next president.

Such is the magnitude of the financial and economic crisis facing the United States and other global economies that the particular actions of political officials such as Paulson and Federal Reserve Chairman Ben Bernanke seem almost irrelevant. Indeed, both Paulson and Bernanke have the unenviable task of cleaning up the mess left by their respective predecessors, who are under growing attack for their policy decisions. A cursory inventory of the major issues facing the industrial nations in terms of banking regulation and financial market structure tells the tale:

**Basel II.** The just-adopted Basel II capital adequacy framework lies in tatters. Under the Treasury's bailout program for the banking sector, for example, banks can get capital infusions from 1 percent to 3 percent of risk-weighted assets. But since the so-called regulators have proven that they don't know how to risk-weight assets, because they're using models based on the same so-called financial methods as those of the banks and the so-called rating agencies, the entire Basel II framework has lost all credibility with investors.

As regulators in the G7 nations ponder a "Basel III" capital adequacy framework, hopefully they will consider whether "risk

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management" in a global sense is really possible, especially as envisioned in the Bank for International Settlements approach to Basel II. Using flawed concepts such as "value at risk or " VaR" to drive a regulatory measure of capital adequacy is silly, yet it is now in the law and regulation in the European Union and will take effect in the United States in January. The more this writer works with risk and analytics professionals, the more I appreciate that the image of rational direction of large enterprises is more hope than reality. Thus, our firm focuses on using verifiable data and classical metrics for rating U.S. banks rather than discredited methods such as those embraced in Basel II.

Whether you are an investor, regulator, or ratings agency, the disruption of the consensus around price and valuation, and therefore the solvency of counterparties, is creating instability, but that process of reformulating pricing methods requires time and focus. And the debate over the new framework for relating price to value (or risk) is only beginning. On October 21, 2008, former Citigroup Chairman John Reed commented in a letter in the *Financial Times* that, going back a decade or more, two misjudgments where made:

> "The first was to assume that markets could better manage and absorb risk than institutions. Most of us believe that markets are the best at allocating capital … Our second error was to embrace the notion of risk-adjusted capital, saying, in essence, that we know where the risks are. This too was accepted as a move towards using capital more efficiently, meaning less of it in relation to gross assets. It seems pretty clear, and it has probably always been that we only know where risks are after the fact."

In the wake of the financial crisis in the United States, leaders in the regulatory arena are going to be forced to stop trying to understand and accommodate bank risk methods, and instead start to proscribe those products and activities which are clearly unsafe and unsound. Just because a bank can do something in finance does not mean that we must or even should try to make it fit into a rational regulatory framework. Whatever the regulatory framework that emerges from this crisis, it is pretty clear that the bold leaders in the investment world will be forced to spawn "innovations" in privately owned firms outside the banking industry and the public safety net.

**Market Structure.** On April 27, 2008, the *New York Times* described how former Fed Chairman Alan Greenspan and former Treasury Secretaries Larry Summers and Robert Rubin coordinated to undermine efforts by Commodity Futures Trading Commission Chairperson Brooksley Born to impose greater federal oversight of over-the-counter derivatives markets. They report: "On at least one occasion, Mr. Rubin lined up with Mr. Summers as well as Mr. Greenspan to block a 1998 proposal by the Commodity Futures Trading Commission under Ms. Born that would have effectively moved many derivatives out of the shadows and made them subject to regulation."

The *New York Times* has since published several other articles discussing how Rubin, Summers, Greenspan and others worked tirelessly to prevent Washington from demanding increased oversight of the OTC derivatives. Note below Born's comments of a decade ago regarding the Long-Term Capital Management collapse, which highlight those very same issues which led to the collapse of Bear Stearns earlier this year, namely the systemically unstable nature of an OTC market structure. Note too that over the intervening decade nothing happened in Washington to effectively address these issues:

> "The events surrounding the financial difficulties of Long-Term Capital Management L.P. raise a number of important issues relating to hedge funds and to the increasing use of OTC derivatives by those funds and other institutions in the world financial markets. The issues most directly posed by LTCM include lack of transparency, excessive leverage, insufficient prudential controls, and the need for coordination and cooperation among international regulators. I wel-

> come the heightened awareness of these issues that the LTCM matter has engendered and believe it is critically important for all financial regulators to work together closely and cooperatively on them. Therefore, I applaud Secretary of the Treasury Robert Rubin's call for meaningful studies by the President's Working Group on Financial Markets on hedge funds and on OTC derivatives and look forward to working with him and the other members of the Working Group."
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> Brooksley Born, Chairperson
> Commodity Futures Trading Commission
> November 13, 1998

In the view of this writer, Greenspan, Summers, and Rubin all acted—or failed to act—to enable Wall Street's quest for higher profits via the opaque OTC market structure model and did so at the expense of the public interest. Instead of a truly free and transparent securitization market where occasionally a player does fail, today's OTC jungle ensures the destruction of a significant portion of capital deployed by both dealers and investors. How does this serve the interest of investors or the marketplace? As the noted historian and monetary economist Anna Schwartz has said several times this year, Greenspan *et al.* ought to be held to account publicly regarding their actions. And Paulson has been entirely silent on this issue.

The U.S. Congress, the major regulators and industry groups such as the President's Working Group on Financial Markets, and two presidential administrations from different political parties, all collaborated to bring the financial crisis involving subprime debt and OTC securities to fruition. While talking about "innovation" and "competitiveness," the U.S. political elite and their clients on Wall Street authored the subprime crisis from beginning to end, specifically by allowing the OTC marketplace to grow to the point where it threatens the safety and soundness of large banks.

Paulson was part of the problem here, but before he took over at Treasury. When he ran Goldman Sachs, arguably among the more highly leveraged firms on Wall Street, he oversaw one of the most aggressive players in the market for credit default swaps or "CDSs." Indeed, many critics of Paulson believe that the decision in September by the Fed and Treasury to rescue the insurer AIG was an explicit attempt to shield Goldman Sachs and other major derivatives dealers from a bankruptcy.

The real irony of the past year or more is that the OTC market structure has been a catastrophe for many dealers, some of whom laid out millions of dollars in lobbying fees to make the OTC market a reality. With the failure of Bear Stearns in May, Lehman Brothers and Washington Mutual in September, the forced sale of Merrill Lynch to Bank of America and Wachovia Bank to Wells Fargo, the stewardship of Paulson and Bernanke has been an unmitigated disaster for the U.S. economy and financial system, but the adjustment process with the banks is only just begun.

Perhaps the chief sin of Paulson and Bernanke both is their inability—refusal, really—to acknowledge the warning signs of a coming crisis. As Roger Kubarych, chief U.S. economist at UniCredit Global Research, noted in an interview with this writer, the failure of New Century Financial early in 2007 "provided incontrovertible evidence, after some rumbling in the hilltops, of an earthquake in the mortgage securities market." According to Kubarych, at a meeting of all of the major investment houses at the Federal Reserve Bank of New York after the bankruptcy of New Century, one of the great thinkers of Wall Street laid out a scenario of how New Century's failure was terrible and had grave consequences for the markets. But neither Bernanke nor Paulson took heed of the warning.

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**The Next Crisis: OTC Derivatives.** Our view of the U.S. banking and credit sectors is that the credit adjustment process was nearing halfway at the end of the third quarter of 2008. The first portion of the crisis, begun with the collapse of New Century Financial early in 2007, was about loss recognition. The headlines concerning insurers such as MBIA and lenders such as Countrywide Financial, now owned by Bank of America, were dominated by mark-to-market losses, largely as a result of the implementation of the new rule regarding "fair value" accounting. Neither Paulson nor Bernanke foresaw nor understood the impact of imposing fair value accounting on a speculative market bubble.

The second phase of the crisis is unfolding now and is more focused on loss realization, that is, the sale of distressed assets and the charge-off of bad or doubtful credits.

Loss rates reported by banks in the third quarter of 2008 continue to climb rapidly and new provisions are flowing into reserves at more than two times the current charge-off rates. Based on our estimates, these loss rates could force large banks such as JPMorgan Chase into the arms of the government when additional equity injections are required, perhaps as early as the fourth quarter of 2008.

The third phase of the crisis involves a broadening of losses from asset classes such as mortgages and financials into

a more general credit-loss peak cycle affecting the entire economy. There will be continuing need for government support of large banks as on- and notional off-balance sheet obligations become very real and must be funded. Indeed, the political rhetoric of getting banks to "start lending again" is entirely at odds with the economic situation inside the banks.

In 2009 and beyond, the funding needs for financial institutions are going to be dominated by first loss absorption, then reserve/capital replacement, and finally balance sheet expansion via new lending. The full weight of the funding required to liquefy/subsidize the $55 trillion OTC credit default and other derivatives is still not recognized by the Fed and other G7 central banks. Indeed, the OTC derivative market encouraged and fostered by Chairman Greenspan, the Bank for International Settlements, and other global regulators may now be a dead weight that drags down the global economy for years to come.

Consider the ongoing discontinuity in the dollar LIBOR in Europe. Regulators such as Paulson and Bernanke publicly stated that their efforts at providing liquidity to the markets will restore credit availability to private markets. But what neither the regulators nor the media understand is that the bad effect of the CDS market comes not merely from when there is market dysfunction and an individual counterparty fails. That happens often enough and the prime broker-dealers like Citigroup and JP Morgan clean up the mess quietly so as not to roil the markets. Remember, the dealer already owns the counterparty's collateral through the credit agreement, so there is no point forcing the issue with a messy and noisy bankruptcy. Right? This is why the media rarely hears of failed trades in CDSs.

No, as with the repatriation of the structured investment vehicles onto the balance sheets of Citigroup and other money center banks, the true significance of CDSs comes when the markets function smoothly, as after a default event like Lehman. The trigger event putting a single-name CDS contract in the money results in a liquidity-raising event for the seller of protection, who must fund the purchase of the debt at par less recovery value—whether or not the other party actually owns the debt!

This process of funding the CDS is reportedly a factor behind the high rates of dollar LIBOR in London and illustrates how cash settlement derivatives actually multiply risk without limit. Through the wonders of cash settlement, the derivative-happy squirrels at the Federal Reserve, Bank for International Settlements, and International Swaps and Derivatives Association created a liquidity-sucking monster in OTC derivatives that multiplies risk many times, for example, above the amount of underlying debt of Lehman Brothers.

In October, my firm reported that there are more than a few EU banks that wrote CDSs on Lehman over the past several years, CDSs which were written at relatively tight spreads. These banks have chosen to take delivery on the Lehman debt, forcing them to fund a nearly 100 percent payout on the collateral. A certain German Landesbank, for example, took delivery on $1 billion in Lehman bonds that are now worth $30 million, and had to fund same. Does this example perhaps suggest a reason why the bid side of dollar LIBOR in London has been so strong?

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As one veteran CDS trader told me in October: "It's not that people can't fund, it is that people have got to fund these CDS positions. These banks don't have access to sufficient liquidity internally to fund, so they hit the London markets… The Fed and the other central banks must start to deal with the huge overhang of currently hidden funding needs from the CDSs and other derivatives." Another market observer suggests this is precisely why the Fed and other central banks have been furiously putting reciprocal currently swap lines in place.

As consumer and commercial default rates in the United States rise, the normal operation of the OTC derivatives markets is creating a cash position that must be funded in the real world and is thus distorting these benchmark cash markets such as LIBOR. This distortion is magnified by the dearth of liquidity due to the breakdown in the rules regarding valuation and price. So far, the Fed and other central banks have addressed the on-balance-sheet liquidity needs of global banks.

But as default rates rise in the United States in 2009 and beyond, funding the trillions of dollars in notional off-balance-sheet speculative positions in CDSs, which become very real and require funding when a default occurs, could prolong the economic crisis and siphon resources away from the global economy. That, at the end of the day, may be the bitter legacy that Alan Greenspan, Hank Paulson, and Ben Bernanke may leave behind. ◆