TESTIMONY

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HOUSE OF REPRESENTATIVES

COMMITTEE ON AGRICULTURE

HEARING TO
REVIEW THE ROLE OF CREDIT DERIVATIVES IN THE
U.S. ECONOMY

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I would like to thank Chairman Collin C. Peterson, Ranking Member Bob Goodlatte and the members of the House Agriculture Committee for inviting me to testify today at this hearing to review the role of credit derivatives in the U.S. economy.

My name is Eric Dinallo and I am Insurance Superintendent for New York State.

What I would like to discuss with you today is one particular kind of derivative--credit default swaps--which have played a major role in the financial problems we now face.

Let me first establish why the insurance regulator for New York is a relevant authority on credit default swaps. I will expand on theses issues at greater length, but to provide a context, I will start with a brief summary.

As credit default swaps were developed, there was a question about whether or not they were insurance. Since initially they were used by owners of bonds to seek protection or insurance in the case of a default by the issuer of the bonds, this was a reasonable question. In 2000, under a prior administration, the New York Insurance Department was asked to determine if swaps were insurance and said no. That is a decision we have since revisited and reversed as incomplete. I will provide more detail on these important decisions shortly.

In addition, since I took office in January 2007, the impact of credit default swaps has been one of the major issues we have had to confront. First, we tackled the problems of the financial guaranty companies, also known as bond insurers. Credit default swaps were a major factor in their problems. More recently, we have been involved in the rescue of AIG. Again, credit default swaps were the biggest source of that company’s problems.

Through these experiences, we have needed to carefully study the history and issues surrounding credit default swaps. And we have learned the hard way their impact on markets and companies.

I am honored to have this opportunity to share with you what we have learned from this hard won experience.

First, let’s discuss what a credit default swap is and the different kinds of credit default swaps. A credit default swap is a contract under which the seller, for a fee, agrees to make a payment to the protection buyer in the event that the referenced security, usually some kind of bond, experiences any number of various “credit events”, such as bankruptcy, default, or reorganization. If something goes wrong with the referenced entity, the protection buyer can put the bond to the protection seller and be made whole. Or a net payment can be made by the seller to the buyer.

Originally, credit default swaps were used to transfer and thus reduce risk for the owners of bonds. If you owned a bond in company X and were concerned that the company might default, you bought the swap to protect yourself. The swaps could also be used by banks who loaned money to a company. This type of swap is still used for hedging purposes.

Over time, however, swaps came to be used not to reduce risk, but to assume it. Institutions that did not own the obligation bought and sold credit default swaps to place what Wall Street calls a directional bet on a company's credit worthiness. Swaps bought by speculators are sometimes known as "naked credit default swaps" because the swap purchasers do not own the underlying obligation. The protection becomes more valuable as the company becomes less creditworthy. This is similar to naked shorting of stocks.

I have argued that these naked credit default swaps should not be called swaps because there is no transfer or swap of risk. Instead, risk is created by the transaction. For example, you have no risk on the outcome of the third race until you place a bet on horse number five to win.

We believe that the first type of swap, let's call it the covered swap, is insurance. The essence of an insurance contract is that the buyer has to have a material interest in the asset or obligation that is the subject of the contract. That means the buyer owns property or a security and can suffer a loss from damage to or the loss of value of that property. With insurance, the buyer only has a claim after actually suffering a loss.

With the covered swaps, if the issuer of a bond defaults, then the owner of the bond has suffered a loss and the swap provides some recovery for that loss. The second type of swap contains none of these features.

Because the credit default swap market is not regulated, we do not have valid data on the number of swaps outstanding and how many are naked. Estimates of the market were as high as $62 trillion. By comparison, there is only about $6 trillion in corporate debt outstanding, $7.5 trillion in mortgage-backed debt and $2.5 trillion in asset-backed debt. That's a total of about $16 trillion in debt private sector debt.

Now, I think it would be useful to go into some of the history.

Betting or speculating on movements in securities or commodities prices without actually owning the referenced security or commodity is nothing new. As early as 1829, "stock jobbing", an early version of short selling, was outlawed in New York. The Stock Jobbing Act was ultimately repealed in 1858 because it was overly broad and captured legitimate forms of speculation. However, the issue of whether to allow bets on security and commodity prices outside of organized exchanges continued to be an issue.

"Bucket shops" arose in the late nineteenth century. Customers "bought" securities or commodities on these unauthorized exchanges, but in reality the bucket shop was simply booking the customer's order without executing on an exchange. In fact, they were simply throwing the trade ticket in the bucket, which is where the name comes from, and tearing it up when an opposite trade came in. The bucket shop would agree to take the other side of the customer's "bet" on the performance of the security or commodity.

Bucket shops sometimes survived for a time by balancing their books, but were wiped out by extreme bull or bear markets. When their books failed, the bucketeers simply closed up shop and left town, leaving the "investors" holding worthless tickets.

The Bank Panic of 1907 is famous for J.P Morgan, the leading banker of the time, calling all the other bankers to a meeting and keeping them there until they agreed to form a consortium of bankers to create an emergency backstop for the banking system. At the time there was no Federal Reserve. But a more lasting result was passage of New York's anti-bucket shop law in 1909. The law, General Business Law Section 351, made it a felony to operate or be connected with a bucket shop or "fake exchange." Because of the specificity and severity of the much-anticipated legislation virtually all bucket shops shut down before the law came into effect, and little enforcement was necessary. Other states passed similar laws.

Section 351 prohibits the making or offering of a purchase or sale of security, commodity, debt, property, options, bonds, etc. without intending a bona fide purchase or sale of the security, commodity, debt, property, options, bonds, etc. If you think that sounds exactly like a naked credit default swap, you are right. What this tells us is that back in 1909, 100 years ago, people understood the risks and potential instability that comes from betting on securities prices and outlawed it.

With the growth of various kinds of derivatives in the late 20th Century, there was legal uncertainty as to whether certain derivatives, including credit default swaps, violated state bucket shop and gambling laws.

The Commodity Futures Modernization Act of 2000 ("CFMA"), signed by President Clinton on December 21, 2000, created a "safe harbor" by (1) preempting state and local gaming and bucket shop laws except for general antifraud provisions, and (2) exempting certain derivative transaction on commodities and swap agreements, including credit default swaps, from CFTC regulation.

CFMA also amended the Securities and Exchange Acts of 1933 and 1934 to make it clear that the definition of "security" does not include certain swap agreements, including credit default swaps, and that the SEC is prohibited from regulating those swap agreements, except for its anti-fraud enforcement authority.

So by ruling that credit default swaps were not subject to state laws or SEC regulation, the way was cleared for the growth of the market. But there was one other issue. If the swaps were considered insurance, then they would be regulated by state insurance departments. The capital and underwriting limits in insurance regulation would threaten the rapid growth in the market for these derivatives.

So at the same time, in 2000, the New York Insurance Department was asked a very carefully crafted question. "Does a credit default swap transaction, wherein the seller will make payment to the buyer upon the happening of a negative credit event and such payment is not dependent upon the buyer having suffered a loss, constitute a contract of insurance under the insurance law?"

Clearly, the question was framed to ask only about naked credit default swaps. Under the facts we were given, the swap was not insurance, because the buyer had no material interest and the filing of claim does not require a loss. But the entities involved were careful not to ask about covered credit default swaps. Nonetheless, the market took the Department's opinion on a subset of credit default swaps as a ruling on all swaps.

In sum, in 2000 as a society we chose not to regulate credit default swaps.

Why did that matter? As we have seen, the financial system has been placed in peril because there was no comprehensive management of counterparty risk. Deals were made privately between two parties. These bilateral arrangements mean that there are no standards for the solvency of counterparties. The buyer does not know how much risk the seller is taking on. And there are no requirements for the seller to hold reserves or capital against the risks it is taking on by selling swaps.

None of this was a problem as long as the value of everything was going up and defaults were rare. But the problem with this sort of unregulated protection scheme is that when everyone needs to be paid at once, the market is not strong enough to provide the protection everyone suddenly needs.

Unlike insurance, credit default swaps are marked to market. That means, the value of the swap reflects the current market value, which can swing sharply and suddenly. Value changes require the sellers to post collateral. Sudden and sharp changes in the credit rating of the issuer of the bonds or of the bonds themselves can produce large swings in the value of the swaps and thus the need to post large and increasing amounts of collateral. That capital strain can produce sudden liquidity problems for sellers. The seller may own enough assets to provide collateral, but the assets may not be liquid and thus not immediately accessible. When many sellers are forced to sell assets, the price of those assets falls and sellers are faced with taking large losses just to meet collateral requirements. As the prices of the assets are driven down by forced sales, mark-to-market losses increase and the collateral posting cycle continues. Meanwhile, the underlying assets may continue to perform; paying interest and principal in full.

The above is a substantial part of the problem at AIG. A ratings downgrade on September 15 produced immediate collateral calls. The company did not have sufficient liquid assets.

In addition, chains of counterparty exposures mean that if one counterparty fails, others with exposure to that counterparty may also fail, setting off a chain reaction. Many financial institutions bought protection from AIG, and there was great uncertainty as to whether all of these institutions could survive AIG's failure.

Was the AIG rescue necessary? I believe it was. Thanks to the protective moat created by state regulation, AIG's insurance operations were insulated from the problems in other AIG subsidiaries and are solid, profitable companies. Many of AIG's companies are leaders in their markets. They have substantial value. But that value could not be realized over a weekend. The rescue will provide time for an orderly restructuring of AIG's operations. It is possible that AIG will survive, as a smaller but much stronger insurance-focused enterprise. At least some of its operations will be sold.

Some argue that the company should have been filed for bankruptcy, as Lehman did. AIG is a "systemically important company." It has business relations with just about every major bank in the world. At a time when the financial system and in particular the credit markets are already deeply troubled, the risks of allowing AIG to file for bankruptcy were, in my opinion, just too great. The New York Federal Reserve Bank and the Treasury appear to share that view.

On September 22, we announced that New York State would, beginning in January, regulate the insurance part of the credit default swap market which has to date been unregulated—the part which the Insurance Department has jurisdiction to regulate.

That announcement played an important role in spurring national discussion about a comprehensive regulatory structure for the CDS market. The result has been exactly what was envisioned—a broad debate and discussion about the best way to bring controls and oversight to this huge and important market and concrete progress toward a centralized risk management, trading and clearing system. After our announcement, SEC Chairman Cox asked for the power to regulate the credit default swap market. The New York Federal Reserve began a series of meetings with the dealer community to discuss how to proceed.

We believe that there are appropriate uses for credit default swaps. We acknowledge that some amount of speculation can provide useful information and market liquidity. We also recognize that the best route to a healthy market in credit default swaps is not to divide it up among regulators. It would not be effective or efficient for New York to regulate some transactions under the insurance law, while other transactions are either not regulated or regulated under some other law. The best outcome is a holistic solution for the entire credit default swap market.

Last Friday the Presidents Working Group, which the New York Insurance Department has advised on insurance-related matters, announced a memorandum of understanding among the Federal Reserve, the SEC and CFTC to cooperatively implement a central counterparty plan for CDS transactions. While these plans have not been finalized, we are hopeful that this will be the first step toward comprehensive federal oversight.

The New York Federal Reserve Bank and the New York Banking Department are working with one of the proposed central counterparties to establish a New York trust company to serve as a clearing house for credit default swaps. Processing this application is a top priority of the Superintendent of Banks and the Banking Department.

Effective regulation of credit default swaps should include the following provisions:

- All sellers must maintain adequate capital and post sufficient trading margins to minimize counterparty risk.
- A guaranty fund should be created that ensures that a failure of one seller will not create a cascade of failures in the market.
- There must be clear and inclusive dispute resolution mechanisms.
- To ensure transparency and permit monitoring, comprehensive market data should be collected and made available to regulatory authorities.
- The market must have comprehensive regulatory oversight, and regulation cannot be voluntary.

Based on the developments reported on by the President's Working Group, it is clear they are committed to comprehensive and effective federal oversight of credit default swaps. My conversations with your members and the members of the Senate have also persuaded me that Congress is committed to producing a complementary legislative framework. As this process unfolds during the next Congress, my office will be actively following and assisting the federal government's efforts. Accordingly, New York will delay indefinitely our plan to regulate part of this market.

We understand that the market for credit default swaps is large and complex and it will take time to complete a holistic solution. But while we support these beginning efforts, we also recognize that they do not yet constitute a completely transparent and fully regulated market. We urge the industry, federal agencies and Congress to continue working until that essential goal is reached. At that point, we will be prepared to consider any necessary changes in state law to prevent problems that might arise from the fact that some swaps are insurance.

The unregulated marketplace in credit derivatives was a central cause of a near systemic collapse of our financial system. Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and the bond insurance companies. A major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate. This lack of regulation has been devastating for thousands of New Yorkers and every taxpayer in the United States. We must see that this does not happen again.

New York stands ready to work expeditiously with all concerned to find a workable solution to the problem of how to regulate credit default swaps.

Thank you and I would be happy to answer any questions.