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## Takeaways from Research and Investigation Plan on Complex Financial Derivatives

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**TAKEAWAYS FROM RESEARCH AND INVESTIGATION PLAN  
ON COMPLEX FINANCIAL DERIVATIVES**

**9/4/2010**

## **CONTENTS**

I.	Takeaways from the Complex Financial Derivatives Working Group.....	3
II.	Specific Takeaways on which No Consensus was Reached.....	4
III.	Takeaways from the Staff.....	6

## **I. CONSENSUS TAKEAWAYS FROM THE COMPLEX FINANCIAL DERIVATIVES WORKING GROUP**

### **AIG**

1. There was a failure of corporate management at AIG.
2. Compensation and compensation incentives were misaligned with long term performance of AIG.
3. AIG management, including the management of AIGFP, and its auditors failed to properly disclose losses to the public and shareholders in December 2007.
4. AIG failed because of its enormous sales of CDSs on CDOs and other instruments without having to put up collateral, set aside capital reserves or hedge its exposure.

### **Credit Default Swaps and Other Credit Derivatives**

1. The use of CDS helped to fuel securitization and the housing bubble.
2. Derivatives were used to hedge by issuers and so facilitated securitization.
3. Synthetic and hybrid CDOs, consisting of CDSs allowed securitization to continue and expand.
4. CDSs were used by certain large hedge funds, derivatives dealers in their proprietary trading (including Goldman Sachs) and other speculators to bet against the housing market and various mortgage securities and loans.
5. Speculators demand for such CDSs on the housing market helped to fuel the creation and sale of synthetic and hybrid CDOs and thus extended and amplified securitization.
6. The AIG/Goldman relationship/disagreements exposed a number of important issues: the lack of effective price discovery, the lack of transparency around significant transactions affecting the larger marketplace, the difficulty of establishing mark to market prices for illiquid securities, and the potential for price manipulation or distortions (e.g. did Goldman drive prices down in this non-transparent market because it was short on the housing market?)

### **All OTC Derivatives**

1. The growth in speculation in derivatives contributed to a number of asset bubbles in addition to the housing bubble, including 2008 bubbles in energy and agricultural

products. (Commodity index swaps, which facilitate speculation in agriculture and energy, for example, increased more than ten fold from 2003 to 2008, at the time when the oil market and the market for various agricultural products were experiencing bubbles.)

2. Some large over the counter derivatives dealers were considered by regulators to be too big to fail in significant part because of the interconnections created by their hundreds of thousands or millions of derivatives contracts and were therefore rescued through government bail outs, including AIG and Bear Stearns.

### **Lack of Regulation**

1. Lack of regulation allowed the OTC derivatives markets to grow without transparency.
2. The risks posed by derivatives is directly related to the lack of regulation of the market caused by the Commodity Futures Modernization Act of 2000 ("CFMA"), which expressly eliminated virtually all federal regulatory power and government oversight over the OTC derivatives market and preempted state gaming and bucket shop laws as well.
3. State insurance regulators did not regulate the sale of credit default swaps in part because of the deregulatory effect of the CFMA.
4. The Office of Thrift Supervision was ill equipped to oversee AIG and failed in its mission. It did not have the resources, capability, or focus to supervise an institution of the scale and complexity of AIG.
5. State insurance supervisors did make some headway in reducing the securities lending portfolio, but were poorly positioned to oversee AIG.

## **II. SPECIFIC TAKEAWAYS ON WHICH NO CONSENSUS WAS REACHED**

### **Credit Default Swaps and Other Credit Derivatives**

1. Credit derivatives increased the amount of exposure to mortgage credit in the system, by increasing both the amount of losses and the number of investors experiencing losses when defaults rose, as well as increasing the gains.
2. The possible collapse of AIG could have brought down its counterparties and then in turn their counterparties, causing cascading losses and collapses throughout the financial system and necessitated the government bailout
3. Shorting the housing bubble tended to reduce the bubble, to the degree it made being long on the housing market more expensive.

4. When the housing market did collapse, the enormous and highly leveraged bets on the housing market through the use of CDSs (as well as other credit derivatives including trading on the ABX) caused the credit exposure to the collapse to be substantially larger than the mortgages involved.
5. When CDS protection of CDOs and other loans was weakened or lost because of fears that AIG and others would default on their obligations, the value of the underlying loans diminished.
6. These synthetic instruments extended the scale and duration of the mortgage securities bubble, with synthetic securities continued to be issued even after the housing market began declining and the mortgage market was imploding (issuance continued even after the failure of major subprime lenders).

### **All OTC Derivatives**

1. The over-the-counter derivatives market created significant systemic risk in the financial system and helped to fuel the panic in the financial crisis, exposing the system to contagion of cascading defaults and losses.
2. This risk was greatly inflated by the excessive speculation and enormous leverage in the derivatives market.
3. Lack of transparency and effective price discovery in the derivatives market contributed to financial institutions' inability to assess their exposures and those of their counterparties, fueling panic when the housing bubble collapsed.
4. The concentration of risk in the hands of the large OTC derivatives dealers, our largest banks and investment banks, caused by the enormous derivatives positions they held and their exposure to failing institutions through derivatives contracts played a significant role in the uncertainty and panic in the market.
5. The "bank runs" on large OTC derivatives dealers, such as Bear Stearns and Lehman Brothers, included runs on their derivatives operations by their counterparties and potential counterparties. During the panic such dealers also suffered operational difficulties relating to derivatives trading which exacerbated their problems.
6. The complexity of customized derivatives sold by OTC derivatives dealers along with the lack of transparency of the market and the limited access of their customers to relevant information on pricing or risk has apparently caused a great deal of misunderstanding and mispricing of risk. It has also created enormous profits for the derivatives dealers from wide pricing spreads and high fees.
7. The over-the-counter derivatives market experienced a sharp and unprecedented contraction during the last half of 2008.

## **Lack of Regulation**

1. This lack of regulation has also allowed OTC derivatives to be used to evade accounting requirements (e.g., Enron), disguise debt (e.g., Greece), evade tax laws (e.g., the current IRS investigation of the use of equity swaps to evade withholding tax), and get around other regulatory requirements such as insider trading rules, net capital requirements, bankruptcy requirements, etc. This is less important as a direct causal factor.

## **III. STAFF TAKEAWAYS FROM DERIVATIVES HEARING**

1. Credit derivatives led to more credit creation. Credit default swaps on CDOs facilitated the cash ABS CDO market, which facilitated the subprime MBS market. Experts made this argument in interviews with staff prior to the hearing, and Gary Cohn of Goldman Sachs repeated during the hearing that credit would have been more limited without the ability to hedge with derivatives.
2. Credit derivatives affected the location of losses related to mortgage credit in systemically significant ways, by transferring losses from the mortgage market to CDOs and by creating profits for shorts and losses for longs. The long investors that suffered losses included large banks, AIG and the monolines, many of which were determined by supervisors to be systemically significant.
3. Price discovery in the OTC derivatives market was impaired during the financial crisis. The impairment in price discovery undermined the ability of participants in OTC derivatives markets to manage their counterparty credit exposure. And, it led to disputes and delays in correcting for changes in exposures that were caused by changes in prices and interest rates. Transparency is important because of the importance of price discovery and because of its impact on stability (i.e. opaqueness makes system more vulnerable). Commissioners do not yet agree on how important a factor this was in the financial crisis. Staff is preparing data and conducting further interviews on this topic.
4. Derivatives were inadequately collateralized. Commissioners agree that this was the case for AIG. Staff is preparing data on the experience of other market participants.
5. Collateral calls created financial problems for many firms, leading to financial problems and deleveraging (as many firms tried to sell assets to cover their collateral calls), and insolvency in some cases. Commissioners agree this was the case for AIG and the monolines. Staff is preparing data on other market participants.