ON THE MONEY

Credit-default swaps are masquerading as financial products. They should be regulated as insurance products.

ISTOCKPHOTO

Barry Ritholtz

ON INVESTING

Last week, Greece officially defaulted on its debt. (Unofficially, it defaulted long ago.) This formal default on about $100 billion triggered payment of $3 billion in credit-default swaps. These are the non-insurance insurance products that pay off in the event of a default.

Let's take a closer look at the tortured history of the swaps and see why they should be regulated as commercial insurance policies.

Our story thus far: CDS obtained their favored status as unregulated insurance policies courtesy of the Commodity Futures Modernization Act of 2000. It was sponsored by then-Sen. Phil Gramm (R-Tex.) — and benefited Enron, where his wife, Wendy, was a director on the board. The energy company had discovered the fast profit of trading energy derivatives, which was much easier to achieve without those pesky regulations. Late in the year, the CFMA was rushed through Congress. Passed unanimously in the Senate and overwhelmingly in the House, it was mostly unread by Congress or its staffers. On the advice of then-Treasury secretary Lawrence H. Summers, the bill was signed into law by Bill Clinton.

No one associated with this awful legislation has yet to be rebuked for it. Anyone who actually read this debacle and recommended it should be banned for life from having anything to do with public policy or economics.

Why? The act was a radical deregulation of derivatives. It was an example of the now widely discredited belief that banks and markets could self-regulate without problems. Management would never do anything that put the franchise at risk, and if it did, it would be suitably punished by the shareholders.

It didn't quite work out that way. Across Wall Street, nearly all senior management involved escaped with their bonuses and stock options intact. Lehman chief executive Dick Fuld lost hundreds of millions of dollars and now must scrape by on the mere $500 million or so he squirreled away.

The act did more than change the way derivatives were regulated. It annihilated all relevant regulations. First, it modified the Commodity Exchange Act of 1936 (CEA) by exempting derivative transactions from all regulations as either "futures" (under the CEA) or "securities" (under federal securities laws). Further, the CFMA specifically exempted credit-defaults swaps and other derivatives from regulation by any state insurance board or regulator.

Hence, the law created a unique class of financial instruments that was neither fish nor fowl: It trades like a financial product but is not a security; it is designed to hedge future prices but is not a futures contract; it pays off in the event of a specific loss-causing event but is not an insurance policy.

Given these enormous exemptions from the usual rules that govern financial products, you can guess what happened with the swaps. A very specific set of economic behaviors emerged: Companies that wrote insurance typically set aside reserves for expected risk of loss and payout. When it came to swaps, the companies that underwrote them had no such obligation.

This had enormous repercussions. The biggest underwriter of default swaps was AIG, the world's largest insurer. Without that reserve-requirement limitation, it was free to underwrite as many swaps as it could print. And that was just what it did: AIG's Financial Products unit underwrote more than $3 trillion worth of derivatives, with precisely zero dollars reserved for paying any potential claim.

Though this may sound utterly absurd today, circa 2005 it was considered brilliant financial engineering. Consider this quote from Tom Savage, the president of AIG FP: "The models suggested that the risk was so remote that the fees were almost free money. Just put it on your books and enjoy."

Ahhh, free money — how could that dream ever go wrong?

As it turns out, quite easily. Underwriting swaps was enormously lucrative — so long as you don't count that unpleasant crashing and burning into insolvency at the end.

Oh, and that massive $185 billion AIG government bailout. Aside from those tiny hiccups, there was some good money to be made.

It was more than just AIG. While the radical deregulation wrought by the CFMA led to AIG's self-directed collapse, it also helped steer two of the largest securitizers of mortgages — Bear Stearns and Lehman Brothers — into insolvency. Perhaps they were lulled into complacency, believing (wrongly) that they were hedged against losses. The CFMA led to their demise, and it was indirectly responsible for the collapse of Citigroup, Bank of America and Fannie and Freddie. It also was a significant factor in the near-death experiences of Goldman Sachs, Morgan Stanley and quite a few others.

Despite the CFMA's horrific fatality toll, it has never been overturned. Parts of it were modified by Dodd-Frank regulations, but not the insurance exemptions. Today, these swaps are cleared through exchanges or clearinghouses — but they are still exempt from all insurance regulatory oversight. Which is bizarre, because they are little more than thinly disguised insurance products, with the CFMA kicker that there is no reserve requirement.

Which brings us more or less up to date — and onto more topical issues, such as Greece. Two weeks ago, the International Swaps and Derivatives Association said that "based on current evidence the Greek bailout would not prompt payments on the credit default swaps."

That is an odd statement about a tradable asset — based on evidence? Typically, an option or futures contract expires, and it either is in or out of the money. Any tradable asset — stocks, bonds, futures, options, funds, etc. — settles on its own. There is a market price the asset closes at, a total volume of sales, and a final print for the day, month, quarter and year. No interpretation is required. Why on earth would anyone need a committee ruling for a trade?

On Friday, the ISDA committee ruled that Greece formally defaulted. Thank goodness that was cleared up. Had they failed to do so, it would have fatally damaged the swaps market and made sovereign debt financing much more expensive.

What makes this issue so fascinating is not whether Greece has or has not technically defaulted. Rather, it is that there is a committee of conflicted interested parties rendering a verdict on that issue.

Funny, no sort of group declaration is required when a futures contract or an option must settle. No committee decision is required. Which (again) is why credit-default swaps look, sound and act a lot more like insurance than they do other tradable assets.

Why does it matter if swaps are not insurance? In a word, reserves. That is the key difference between insurance and swaps. State insurance regulators actually require reserves from insurers — a lot of reserves — to ensure payments can be made in the event any payable event occurs. The swaps industry does not require reserves. Not even one penny against billions in potential losses.

I think you can see why this matters so much. Swaps are a lot less profitable as an insurance product than they are as a trading vehicle. That is the primary issue that we all should be concerned about. It is exactly how AIG blew itself up. There is nothing that prevents the marketplace from doing it again. We could very well see a repeat unless this gets resolved. Indeed, the odds heavily favor such an event occurring, unless we collectively do something to stop it.

Credit-default swaps are insurance products. It is well past time we regulated them as such.

Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, the Big Picture at Ritholtz.com. Twitter @Ritholtz

---

STEVEN PEARLSTEIN

In setting prices, let competition be the guide

PEARLSTEIN FROM G1

For the moment, the government has come down on the side of lower prices. Under threat that they will be taken to court for conspiring to fix the price of e-books, the book publishers are trying to work out a settlement with Justice Department's antitrust division.

The talks largely focus on two provisions of the publishers' contract with Apple: one that prohibits the publishers from entering into "wholesale" arrangements with Amazon or any other major distributor, and a second that guarantees that no other distributor will be allowed to sell books for less than Apple. It was those provisions, ostensibly imposed by Apple but greatly welcomed by the publishers, which allegedly gave the publishers the incentive and the confidence to challenge their biggest customer, threatening a cut-off of books if Amazon did not accept the new arrangement.

It's not just the government that is after Apple and the publishers, however. Even if they are able to settle this case, they face a class-action lawsuit, filed on behalf of all e-book customers, that is pending in federal court. At stake are several billion dollars in compensation and punitive damages, along with hundreds of millions of dollars in legal fees.

It is certainly possible, as the plaintiffs' lawyers allege, that executives of Apple and the publishing companies did conspire and collude with one another in meetings or e-mails or phone calls. The lawyers claim to have a "confidential" and "highly credible" source who has provided them with documentation of such direct communication. Even if there is no "smoking gun" document, however, it is possible that the publishers were able to tacitly collude through separate conversations with Apple.

It is also possible that the publishers did not collude in any illegal fashion, but simply went along with an offer from Apple that allowed them to do what they had long wanted to do: challenge an Amazon monopoly that was undermining its much larger and more profitable business in printed books.

After all, it's not an illegal price-fixing conspiracy when, for example, American Airlines announces it is charging $25 for checked baggage just hours after United has announced the same thing. So why, argue the publishers, should their near-simultaneous decision to go with Apple be viewed as anything different than "parallel" actions by competitors facing the same market pressures?

One thing that makes it different is that it is happening in a high-tech sector that, by its nature, is prone to winner-take-all competitions. We saw that with IBM in the 1960s, Microsoft in the 1990s and more recently with Google and Facebook. Because of the "network" quality of such industries, customers prefer to do business with the firm that has the most customers. Moreover, once you decide to do business with one company, the cost and hassle involved in shifting to a competitor is sufficiently high that customers tend to be "locked in" to their original choice.

Antitrust regulators have come to believe that, in such industries, restrictive contracts between firms and their customers, or between suppliers and distributors, may not be as benign as free-market economists and judges once believed. Fiona Scott Morton, chief economist at the Justice Department's antitrust division, recently dubbed them as "contracts that reference rivals" and warned companies that such provisions would now be viewed with heightened suspicion.

These restrictions can take the form of steep discounts for customers who do all or most of their business with a dominant supplier, such as Intel used to do with computer chips.

They can take the form of exclusive contracts prohibiting a buyer from dealing with any other seller, or seller with any other buyer, as when a dominant health insurer requires doctors not to participate in another insurer's provider network.

They can take the form, as they did with Apple and the publishers, of "most favored buyer" clauses in which a customer is guaranteed that it will get as good, or better, price as any other customer.

And as with Apple and publishers, it can take the form of restricting sellers from using a different pricing or business model with other customers.

Certainly the government's case and private ones against Apple and the publishers are greatly strengthened by the fact that we no longer buy e-books for $9.99. That's something any judge or juror can understand and probably explains the instinct to settle.

But the danger of regulators and judges focusing solely on short-term price effects is that it can mean turning a blind eye to business practices that temporarily lower prices even as they drive competitors out of business, lock in customers or limit entry into the market by new firms with better products.

Or to put it another way, it's great to be able to buy e-books for $9.99, but maybe not if the alternative is accepting an Amazon monopoly that drives Barnes & Noble and your local bookstore out of business.

The only really safe mechanism for setting price is open competition, says Andy Gavil, an antitrust expert at Howard University, and anything that prevents that ought to be viewed with suspicion. Sounds like good advice to me.

pearlstein@washpost.com

To see previous columns by Steven Pearlstein, see postbusiness.com.

CHRIS RATCLIFFE/BLOOMBERG NEWS

What looked to consumers like a bargain for an e-reader at $9.99 looked to others in the industry like predatory pricing.

Professional Opportunities

Discover a **career** you believe in.

Staying at the forefront of the media industry isn't easy. We need your expertise. Build your career with us, and be a part of our success.

VP & Chief Revenue Officer

An Entrepreneurial, Multimedia Sales and Marketing Leader

The Washington Post is looking for a seasoned, entrepreneurial, multimedia sales and marketing leader who will develop innovative solutions that drive top-line revenue and help us shape our sales and digital business model for years to come. The VP & CRO for The Washington Post will lead the entire digital, print, conference sales, and new revenue generation functions. Reporting to the President and working directly with the CEO and executive leadership team, this crucial position plays a key role in directing the company towards revenue opportunities that maximize the interplay of a B2B and B2C organization.

Qualified candidates will have:

- At least 10 years of revenue generation, digital business development, and strategic leadership experience.
- Extensive experience with digital strategy, pricing, product development, complex sales strategies, negotiations, B2B and B2C sales tactics.
- Proven success in setting the strategic direction of a large, complex, sales and marketing organization that aligns with short- and long-term company goals, and executing with focus and discipline to exceed targets.
- Strong analytical and financial acumen, successfully applied to distinguish between revenue opportunities that can yield material profitability within two to three years from those that cannot.
- Proven success in creating products across multiple platforms, implementing marketing strategies and finding ways to generate revenue from new and existing products.
- Bachelor's degree in business or related field; MBA and previous media experience preferred.

We encourage qualified candidates to submit a cover letter and resume to Leatrice Buck: bucklm@washpost.com; direct line: 202-334-7117.
Please visit www.washingtonpostmedia.com/careers for a detailed job description.

Washington Post Media is committed to diversity in the workplace. We promote a drug-free work environment.

Learn more about Washington Post Media and other career opportunities at **washingtonpostmedia.com/careers**.