

Richard Christopher Whalen

July 13, 2009

The Honorable
Christopher J. Dodd
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Dodd:

Thank you for your June 30, 2009 letter requesting written responses to questions following the hearing on OTC derivatives that the Committee's Subcommittee on Securities, Insurance, and Investment held on June 22, 2009. The questions and my responses follow below:

Questions for Mr. Christopher Whalen, Managing Director, Institutional Risk Analytics, from Senator Bunning:

1a. Do you believe the existence of an actively traded cash market is or should be a necessary condition for the creation of a derivative under law and regulation?

Yes. As I stated in [my prepared remarks](#), where there is no underlying cash market that both parties to a derivatives transaction may observe, then the derivative has no true economic "basis" in the markets, and is entirely speculative. Where there is no cash market, there is, by definition, no price discovery. A derivative that is created without the benefit of an actively traded cash market is essentially a deception. In the case of credit default swaps and other "derivatives" where no actively traded cash market exists, the dealer pretends that a model can serve as a substitute for a true cash market basis. But such a pretense on the part of the dealer is patently unfair and, in my view, is really an act of securities fraud that should be prohibited as a matter of law and regulation.

1b. If not, what specific, objective means besides a cash basis market could or should be used as the underlying relationship for a derivative?

See above. To the extent that the Congress is willing to continue to tolerate speculation in derivatives for which no cash market basis exists and are instead based upon models, then the dealers should be compelled to publish these models on a monthly basis for the entire market to see and assess. Requiring SEC registration might be another effective solution. Enhanced disclosure of models for OTC derivatives would likely lead to a multiplicity of new lawsuits by investors against the OTC derivatives dealers, thus the effect of compelling the disclosure of models used to price OTC derivatives would be to greatly lessen the complexity of these instruments. Think of this as a "market based" solution driven by the trial lawyers.

2. Why should the models to price OTC derivatives not be published? If there is no visible cash basis for a derivative, and the model is effectively the basis, why should the models not be public?

See response to 1b.

3. What is the best way to draw the line between legitimate hedges and purely speculative bets? For example, should we require an insurable interest for purchasers of credit protection, require delivery of the reference asset, or something else?

Allowing speculators using OTC derivatives to effectively take positions against securities and companies in which they have no economic interest is a form of gaming that the Congress and federal regulators should reject. The term "hedge" implies that the user has an economic position or exposure to a form of risk. The use of cash settlement OTC contracts by parties who have no interest in the underlying assets or company creates perverse incentives that essentially equate an owner of an asset with the speculator with no economic interest. The AIG episode illustrates an extreme example of this problem where AIG was actively using derivatives to engage in securities fraud, both for itself and others, and apparently with the full support and knowledge of the OTC dealers. Allowing speculators to use cash settlement OTC derivatives to game against real companies and real assets to which they have no connection creates systemic risk in our financial system and should be prohibited by law and regulation.

4. Is the concern that increased regulation of derivatives contracts in the United States will just move the business overseas a real issue? It seems to me that regulating the contracts written in the U.S. and allowing American firms to only buy or sell such regulated contracts would solve the problem. What else would need to be done?

No. Those critics who proclaim that regulation of OTC derivatives such as CDS will force the activity offshore are mistaken. Where will they take this vile business? London? No. The EU? No. China? No. Russia? No. Let the proponents of this market go where they will. The government of the US should not allow itself to be held hostage by speculators.

The fact is, the US and EU are the only political jurisdictions in the world that are sufficiently confused as the true, speculative nature of CDS to allow their financial institutions to serve as a host for this reckless activity. Regulating the speculative activities of US banks in the OTC derivatives markets and banning all OTC derivatives for which there is no actively traded cash basis market will effectively solve the problem of systemic risk.

5. In addition to the administration's proposed changes to gain on sale accounting for derivatives, what other changes need to be made to accounting and tax rules to reflect the actual risks and benefits of derivatives?

The key change that must be made is to distinguish between true derivatives, where there is an observable cash market basis, and pseudo derivatives based upon models such as CDS and collateralized debt obligations (“CDOs”) which have no observable basis and which have caused such horrible damage to the global financial system. Where there is no active market price for the underlying relationship upon which the derivative is “derived,” then the bank or other counterparty should be required to reserve 100% of the gross exposure of the position to cover the market, liquidity and counterparty risks created by these illiquid, difficult to value gaming instruments. Congress should explicitly forbid “netting” of OTC contracts such as CDS and any other derivative structure for which there is no cash basis market since there is no objective, independent way to value these instruments. How can any financial institution pretend to “manage” the risk of a CDS instrument or CDO when the only objective means of valuation is a private model maintained by a dealer?

6. Is there any reason standardized derivatives should not be traded on an exchange?

No. All derivatives for which there is an active cash market basis may easily be traded on exchanges. Only those OTC derivatives for which there is no cash market and thus no price discovery will not be practical for exchange trading. The problem here is a basic one since the clearing members of an exchange are not likely to be willing to interpose their capital to jointly and severally guarantee a market based on a CDS model. Unless the clearing members and the customers of a partnership exchange possess the discipline of a cash market basis to support and validate valuations, then it is unlikely that an exchange-based approach will be practical.

7. How do we take away the incentive for credit default swap holders to force debtors into bankruptcy to trigger a credit event rather than re-negotiate the debt?

The simple answer is to require that CDS only be held by those with an economic interest in the debtor that is the underlying “basis” for the derivative. If, as under current law and regulation, you allow speculators with no economic interest in a debtor to employ CDS, then all weak banks and companies may be pushed into insolvency by parties whose sole interest is their failure. Allowing speculators to use CDS against debtors in which they have no economic interest essentially voids the traditional social purpose of the US bankruptcy laws, namely a) to recover the maximum value for creditors of the bankruptcy estate in an equal and fair way and b) to provide a fresh start for the company, which has historically been seen as a benefit in social terms. The Congress needs to recall that the requirement imposed in the 18th Century by our nation’s founders to establish federal bankruptcy courts had both a practical and a social good component.

8. How do we reduce the disincentive for creditors to perform strong credit research when they can just buy credit protection instead?

You cannot. CDS is essentially a low-cost substitute for performing actual credit research. As with credit ratings, investors use CDS to create or adjust exposures based

upon market perception rather than a true analysis of the underlying value. And best of all, the spreads that are usually reflected in CDS pricing often are wrong and do not accurately reflect the true economic cost of default. Thus when speculators employ CDS to purchase protection against a default, the pricing is usually well-below the true economic value of the default. Or to put it another way, AIG was not nearly compensated for the risks that it took in the CDS markets – even though AIG was an insurer and arguably should have understood the difference between short-term “price” of an illiquid bond or loan vs. long-term “value” of a default event.

9. Do net sellers of credit protection carry that exposure on their balance sheet as an asset? If not, why shouldn't they?

The treatment of CDS varies by country. All CDS positions, long or short, should be reflected as a contingent liability or asset, and carried on balance sheet in the appropriate way. The treatment used in the insurance industry for such obligations may be the best model for the Congress to consider as a point of departure for any legislation.

10. In her testimony Chairman Schapiro mentioned synthetic exposure. Why is synthetic exposure through derivatives a good idea? Isn't that just another form of leverage?

Yes, it is another form of leverage and Chairman Shapiro addressed this issue directly. When a user of CDS creates the equivalent of a cash market position in a listed security, then that position should be reported to the SEC and disclosed to the marketplace. Allowing speculators to synthetically create the functional equivalent of a cash market position using CDS arguably is a violation of existing law and regulation. Why should an investor be required, for example, to disclose a conventional option to purchase listed shares but not the economic equivalent in CDS? This dichotomy only illustrates the true purpose of CDS, namely to evade established prudential norms and regulation.

11. Regarding synthetic exposure, if there is greater demand for an asset than there are available assets, why shouldn't the economic benefit of that demand – higher value – flow to the creators or owners of that asset instead of allowing a dealer to create and profit from a synthetic version of that asset?

Agreed. One of the pernicious and truly hideous effects of OTC instruments such as CDS is that they equate true “owners” of assets with speculators who create ersatz positions in these assets via derivatives; that is, they “rent” the asset with no accountability to the owner. It could be argued that such activity amounts to an act of thievery and one that is encouraged by federal bank regulators, particularly the academic economists who dominate the Fed's Board of Governors! Since the users of cash-settlement OTC contracts never have to deliver the underlying reference assets to the buyer, there is no economic connection between the real asset and the OTC derivative. Again, to repeat, this activity is best described as gaming, not risk management.

12. One of the arguments for credit default swaps is that they are more liquid than the reference asset. That may well be true, but if there is greater demand for exposure to the asset than there is supply, and synthetic exposure was not allowed, why wouldn't that demand lead to a greater supply and thus more liquidity?

Arguments that CDS are more liquid than the reference assets are disingenuous and stand the world on its head. As above, why allow a derivative at all when there is no cash reference market? Allowing speculators to create a short market in an illiquid corporate bond, for example, via single-name CDS does not improve price discovery in the underlying asset since there is no market in the first place. And since the "players" in this ersatz market are required to neither borrow nor deliver the underlying reference asset, the entire exercise is pointless in terms of price discovery. The only purpose is to allow the large dealer banks to extract supra-normal returns and increase systemic risk. Again, it is just as easy to speculate on the outcome of a horse race as on the price of a CDS since there is no mechanistic connection between the wager and the actual reference "asset" or event.

13. Is there any justification for allowing more credit protection to be sold on a reference asset than the value of the asset?

No. See reply to Question 12.

14. Besides the level of regulation and trading on an exchange, there seems to be little difference in swaps and futures. What is the need for both? In other words, what can swaps do that forward contracts cannot?

A swap and futures/options are functionally equivalent. The OTC swaps for oil or interest rates can be and are actively traded against the corresponding exchange traded products because they share a common cash market basis. The advantage of OTC contracts is that they allow for customization regarding size and time periods for the counterparties. There is nothing inherently wrong with maintaining these two markets, exchange traded and OTC, side by side, so long as a cash market basis for both exists and is equally visible to the buyer and the seller. Only when the cash market basis is obscured or nonexistent does systemic risk increase because a) the pricing is entirely speculative and thus subject to sudden changes in liquidity and b) cash settlement of OTC contracts such as CDS allows the risk inherent due to the lack of true price discovery to expand infinitely.

15. One of the arguments for keeping over the counter derivatives is the need for customization. What are specific examples of terms that need to be customized because there are no adequate substitutes in the standardized market? Also, what are the actual increased costs of buying those standard contracts?

The spreads on OTC contracts generally are wider than exchange traded instruments, a difference that illustrates the inefficiency of OTC markets vs. exchange traded markets. That said, the ability to specify size and duration of these instruments is valuable to end users and the Congress should allow the more sophisticated private participants in the markets to make that choice. For example, if a large energy company or airline wants to enter into a swap to hedge fuel sales or costs, respectively, in a way the exchange traded contracts will not, then the user of derivatives ought to have that choice to employ the OTC instruments. Again, OTC markets in and of themselves are not problematic and do not create systemic risk.

16. There seems to be agreement that all derivatives trades need to be reported to someone. Who should the trades be reported to, and what information should be reported? And is there any information that should not be made available to the public?

All open positions in OTC derivatives above a certain percentage of the outstanding contracts in any market should be a) reported to the CFTC and b) publicly disclosed in aggregate form. Such disclosure would greatly enhance market efficiency, but it does not mitigate the concerns regarding CDS and other contracts for which there is no liquid, actively traded cash basis market. No amount of disclosure can address that basic flaw in the CDS and other markets which lack a cash basis.

17. What is insufficient about the clearing house proposed by the dealers and New York Fed?

*The proposed clearing house is entirely controlled by the dealer banks. As we wrote in *The Institutional Risk Analyst* in May of this year:*

In 2005, the New York Fed began to fear that the OTC derivatives market, at that time with a notional value of over \$400 trillion dollars, was a sloppy mess - and it was. Encouraged by the Congress and regulators in Washington, the OTC market was a threat to the solvency of the entire global financial system - and supervisory personnel in the field and the Fed and other agencies had been raising the issue for years - all to no effect. This is part of the reason why [we recommended to the Senate Banking Committee earlier this year](#) that the Fed be completely relieved of responsibility for supervising banks and other financial institutions.

Parties were not properly documenting trades and collateral practices were ad hoc, for example. To address these problems, the Fed of New York began working with 11 of the largest dealer firms, including Bear Stearns, Merrill Lynch, Lehman, C, JPM, Credit Suisse and [Goldman Sachs]. Among the "solutions" arrived at by these talks was the creation of a clearinghouse to reduce counterparty credit risk and serve as the intermediary to every trade. The fact that such mechanism already existed in the regulated, public markets and exchanges did not prevent the Fed and OTC dealers from leading a multi-year effort to study the problem further - again, dragging their collective feet to maximize the

earnings made from the existing OTC market before the inevitable regulatory clampdown.

For example, in the futures markets, a buyer and seller agreeing to a transaction will submit it to a clearing member, which forwards it to the clearinghouse. As the sell-side counterparty to the buyer and the buy-side counterparty to the seller, the clearinghouse assumes the risk that a party to the transaction might fail to pay on its obligations. It can do this because it is fully regulated and by well capitalized. As the Chicago Mercantile Exchange is fond of saying, in 110 years no futures clearinghouse has ever defaulted.

While the NY Fed believed that a central counterparty was necessary to reduce risks that a major OTC dealer firm might default, the banks firmly resisted the notion. After all, they make billions of dollars each year on the cash and securities which they required their hedge fund, pension fund and other swap counterparties to put up as collateral. Re-pledging or loaning these customer securities to other clients is very lucrative for the dealers and losing control over the clients collateral would dramatically impact large bank profits.

A clearinghouse would eliminate the need for counterparties to post collateral and a lucrative source of revenue for the dealer firms. So they bought the Clearing Corporation, an inactive company that had been the clearinghouse for the Chicago Board of Trade. If they had to clear their trades, the dealer firms reasoned, at least they would find a way to profit by controlling the new clearing firm. Such is the logic of the GSE mindset.

Meanwhile, other viable candidates for OTC derivatives clearing were eager to get into the business, such as the Chicago Mercantile Exchange and the New York Stock Exchange. Both had over 200 years experience in clearing trades and were well suited to serve as the impartial central counterparty to the banks and their customers.

If the NYSE and CME were to trade derivatives, the big banks knew they would not be able to control their fees or capture the profits from clearing. Therefore, they sold The Clearing Corp. to the Intercontinental Exchange, or ICE, a recent start-up in the OTC derivatives business which had been funded with money originally provided by, you guessed it, the banks. In the deal with ICE, the banks receive half the profit of all trades cleared through the company. And the large OTC dealer banks made sure, through their connections with officials at the Fed and Treasury, that ICE was the winner chosen over the NYSE and CME offerings. That's right, we hear that Tim Geithner personally intervened to make sure that ICE won over the NYSE and CME clearing units.¹

¹ See ["Kabuki on the Potomac: Reforming Credit Default Swaps and OTC Derivatives,"](#) *The Institutional Risk Analyst*, May 18, 2009.

18. How do we prevent a clearing house or exchange from being too big to fail? And should they have access to Fed borrowing?

Limit trading in OTC derivatives by a) requiring sellers to deliver the basis of the derivative upon expiration of the contract and b) ban those derivatives for which there is no actively traded cash basis market. If such reforms are enacted, there should be no need for the Fed to ever support a multilateral exchange or clearing house.

19. What price discovery information do credit default swaps provide, when the market is functioning properly, that cannot be found somewhere else?

None. The argument that a derivative can aid in price discovery for an illiquid cash basis is circular and ridiculous. Trading in CDS is merely gaming between the parties vs. current market prices. As mentioned above, most single name CDS trade against the short-term yields/prices of the supposed basis, thus these contracts arguably do not provide any price discovery vs. the true cost of insuring against default. For example, the day before Lehman Brothers filed bankruptcy, the CDS was trading at roughly 700bp over the Treasury yield curve or roughly 7% per year (plus upfront fees totaling another couple of percentage points) to insure against default. Yet when Lehman filed for bankruptcy, the resulting default required the payment of 9,700bp to the buyers of protection or par less the 3% recovery rate determined by the ISDA auction process. Clearly, receiving 7% and having to pay 97% is not an indication of effective price discovery! The sad fact is that many (but by no means all) users of CDS employ these instruments to trade or hedge current market exposures, not to correctly price the cost of default insurance.

20. Selling credit default swaps is often said to be the same as being long in bonds. However, when buying bonds, you have to provide real capital up front and there is a limit to the lending. So it sounds like selling swaps may be a bet in the same direction as buying bonds, but is essentially a highly leveraged bet. Is that the case, and if so, should it be treated that way for accounting purposes?

That is correct. In order to sell a bond short, the seller must be able to borrow the collateral and deliver same. In CDS, since there is no obligation to deliver the underlying basis for the contract, the leverage is far higher and, more important, there is no real connection between the price discovery in the cash market and the CDS. While services such as Bloomberg and others use cash market yields to estimate what they believe the valuation of CDS should be, there is no objective confirmation of this in the marketplace. The buyers of CDS protection should be required to deliver the underlying instrument in order to collect on the insurance. Indeed, this was the rule in the OTC market until the after the bankruptcy of Delphi Corporation.² At a minimum, the

² See Boberski, David, [CDS Delivery Option: Better Pricing of Credit Default Swaps](#), Bloomberg Books (2009), Pages 101-104.

Congress should compel ISDA to roll-back the template for CDS contracts to the pre-Delphi configuration and require that buyers of protection deliver the underlying basis.

21. Why should we have two regulators of derivatives, with two interpretations of the laws and regulations? Doesn't that just lead to regulation shopping and avoidance?

Yes, in terms of efficiency, we should not have two regulators of derivatives, but the purpose of the involvement by the two agencies is not identical. When a derivative results in the creation of the economic equivalent of a listed security, then investors must be given notice via SEC disclosure. It should be possible for CFTC to exercise primary regulatory oversight of these markets while preserving the role of the SEC in enforcing the legal duty to disclose events that are material to investors in listed securities.

22. Why is synthetic exposure through derivatives a good idea? Isn't that just another form of leverage?

Yes, it is another form of leverage against real assets. Like any form of leverage, it must be disclosed and subject to adequate prudential safeguards such as collateral and disclosure.

23. What is good about the Administration proposal?

At least we are now talking about some of the important issues, but the Administration proposal essentially mirrors the position of the large banks and should not be taken as objective advice by the Congress.

24. Mr. Whalen, you suggest making all derivatives subject to the Commodity Exchange Act. The S.E.C. says some derivatives should be treated like securities. Is that an acceptable option?

See response to Question 21.

25. Is there anything else you would like to say for the record?

To repeat my earlier testimony, the supra-normal returns paid to the dealers in the CDS market is a tax. Like most state lotteries, the deliberate inefficiency of the CDS market is a dedicated subsidy meant to benefit one class of financial institutions, namely the large dealer banks, at the expense of other market participants. Every investor in the markets pay the CDS tax via wider spreads and the taxpayers in the industrial nations pay due to periodic losses to the system caused by the AIGs of the world. And for every large, overt failure like AIG, there are dozens of lesser losses from OTC derivatives buried by the professional managers of funds and financial institutions in the same way that gamblers hide their bad bets. How does the continuance of this market serve the public interest?

Questions for Mr. Christopher Whalen, Managing Director, Institutional Risk Analytics, from Senator Reed:

1. Are there differences between the SEC and CFTC's approaches for regulating their respective markets and institutions that we should take into consideration when thinking about the regulation of the OTC derivatives markets?

The CFTC should be tasked with the functional regulation of all derivatives markets. The SEC should cooperate with the CFTC, especially in terms of the disclosure of any derivative that creates the economic equivalent of a position in a listed security.

2. The Administration's proposal would require, among other things, clearing of all *standardized* derivatives through regulated central counterparties (CCPs). What is the best process or approach for defining standardized products? How much regulatory interpretation will be necessary?

The clearing of standardized contracts is a fairly straight-forward proposition and involves risks that may be managed with existing regulation. Perhaps the biggest challenge is to require the terminology used, for example, in a CDS or CDO created from a mortgage backed security, be standardized. As my colleague Ann Rutledge stated in the interview which I included in the hearing record: "The first key issue is that we need to do to reform our markets is to have a standard vocabulary for the definition of what is a delinquency, a default, and loss."

3. Are there key areas of disagreement between market participants about how central counterparties should operate? For example, what are the different levels of access these central counterparties grant to different market participants? What are the benefits and drawbacks of different ways of structuring these central counterparties?

In the OTC derivatives market, only the dealers have access to the clearinghouse. In an exchange based market, all of the participants face the clearinghouse and there is thus far greater equality in terms of price discovery and execution cost. From this perspective, an exchange type model is far superior, especially seen from the perspective of non-dealer participants.

4. One key topic touched on at the hearing is the extent to which standardized products should be required to be traded on exchanges. What is your understanding of any areas of disagreement about how rigorous new requirements should be in terms of mandating, versus just encouraging, exchange trading of standardized OTC derivatives?

Standardized products do not have to be traded on an exchange. The mere fact of standardization, as in the case of currency and interest rate swaps, will have the

desired positive benefits. In many respects, the issue of standardization is a canard and misses the true public policy issues posed by certain OTC derivatives such as CDS in terms of a) the lack of an actively traded cash basis market and b) the creation of excessive risk in the financial system by allowing cash settlement.

5. Can you share your views on the benefits of customized OTC derivatives products? About how much of the market is truly customized products?

See answer to Question 15 above.

6. The Administration's proposal would subject the OTC derivatives dealers and all other firms whose activities in those markets create large exposures to counterparties to a "robust and appropriate regime of prudential supervision and regulation," including capital requirements, business conduct standards, and reporting requirements. What legislative changes would be required to create margining and capital requirements for OTC derivative market participants? Who should enforce these requirements for various market participants? What are the key factors that should be considered in setting these requirements?

Under current law, the Fed and SEC already have the ability to impose such a regime. The only lacking is the will to regulate. The Congress does not need to pass major legislation. What is required is congressional oversight of the Executive Branch and, if needed, action to compel the Fed and Treasury to serve the public interest instead of the narrow interests of the largest dealer banks. If the Fed and Treasury are unable or unwilling to take the lead on requiring "robust and appropriate regime of prudential supervision and regulation" for the large banks that control the OTC markets, then the Congress should follow my recommendation and strip the Treasury and Fed of all powers in terms of regulating and supervising banks and create a new prudential regulator that is insulated from the partisan politics of Executive Branch appointments. The biggest problem facing the US today in terms of financial regulation is the capture of regulators by the banks which they are supposed to supervise!

7. One concern that some market participants have expressed is that mandatory margining requirements will drain capital from firms at a time when capital is already highly constrained. Is there a risk that mandatory margining will result in companies choosing not to hedge as much and therefore have the unintended consequence of increasing risk? How can you craft margin requirements to avoid this?

This seems to be a false argument. Dealers lacking capital to cover their risk should reduce those risk and related leverage. Why should dealers be able to access markets via OTC markets and thereby evade the leverage, margin limits and prudential regulations that have been long-established in organized markets? The more leverage that is available to market participants via OTC

derivatives, the greater the systemic risk. Thus it seems that the Congress, if it truly wishes to limit systemic risk, must conform the margin requirements in the OTC markets to those prevailing elsewhere in the US financial markets. To do otherwise is inconsistent and would seem to undermine the whole purpose of financial regulation.

8. Is there a risk that regulating the OTC derivatives markets will dramatically alter the landscape of market participants or otherwise have unintended consequences we aren't aware of?

As I mentioned in my testimony, the chief result of regulation will be to lessen the supra-normal returns earned by the dealers in the OTC markets and thereby expose the fundamental lack of profitability in these institutions. If the Congress has the courage and sense of purpose to reject the pretense that OTC markets for instruments such as CDS actually enhance market stability or bank profits on a risk adjusted basis, then we can return banks to being what they should be – namely low-risk utilities – and end the threat of systemic risk one and for all. So long as the Congress refuses to act, then the most irresponsible and aggressive speculators will continue to use our banking system to create ever more complex and opaque securities, and systemic risk will increase and eventually destroy our economy and our nation.

Please let me know if you have any questions about my responses.

Yours,

A handwritten signature in black ink, appearing to read 'C. Whalen', with a long horizontal flourish extending to the right.

Christopher Whalen