

Derivatives Are Not To Blame June 22, 2010 01:57 PM GMT

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I am a derivatives partner in the law firm Cadwalader, Wickersham & Taft. Last week I had the dubious distinction of being featured in an article on the ISDA Conference in San Francisco. This article was headlined "C.D.O. Days, S&M Nights at Derivatives Conference" and used this sensationalistic hook to suggest that not only had the derivatives industry caused the financial meltdown of the world economy but that the members of the industry are also somehow morally degenerate.

This vilification of the finance industry in general, and derivatives in particular, is neither accurate in assessing the reasons for the financial crisis nor useful in crafting legislation to reduce the likelihood and severity of future financial crises. I am neither an economist, a regulator nor a legislator, but have practiced in the areas of derivatives, securitization and financial products for over twenty five years and have the following observations regarding the varied "causes" of the financial crisis.

- **Technology, Mathematical Models** - Advances in computer technology have allowed for complex risk modeling. This modeling was used by rating agencies in rating CDOs and mortgage backed securities, internal risk managers in evaluating value at risk or VAR risk exposures and regulators in risk based capital models. During the crisis this modeling proved an unsatisfactory predictor of the performance of complex securities and of the risk they posed. Consideration should be given as to how to better understand the uses and limitations of complex financial modeling for risk and rating determinations. Also models are only as good as their inputs and many models failed to appreciate how new negative amortization, interest only or other subprime mortgage innovation default and recovery history would differ from the available histories which were based on 30 year fixed rate mortgages with sizable down payments.
- **Correlation Fallacy** - The large majority of financial institutions, as well as investors, rating agencies and government regulators, believed that holding a geographically diverse mortgage portfolio would provide protection from declines in housing prices. This was based on the belief that housing prices are not correlated across different geographical markets i.e., housing may have gone down in Houston, LA or NY but a geographically diverse portfolio was not correlated and nationwide housing had never dropped since the mid 1930s. This assumption regarding lack of correlation (not alchemy) was the reason CDOs and super senior derivative tranches could be rated AAA. However, this non correlation assumption did not hold true and was a major reason for failed ratings, failed monolines as well as the AIGFP CDS debacle. Thought needs to be given as to how to protect against the potential for faulty assumptions used in mathematical modeling and rating processes.
- **Bad Credit** - Every week the FDIC shuts down four or five insured institutions. These institutions generally are not large users of derivatives and securitization. Rather these small and mid sized banks, whose failures deplete the FDIC insurance fund, lost money the old fashioned way - making overly optimistic loans to builders and developers. These banks had plenty of "skin in the game" and did not rely on complex models or securitization or derivative structures: they simply made bad credit decisions and held too many loans that went into default with not very good collateral.
- **Democratization of Finance** - As Robert Shiller of Yale has observed, the last twenty five years has seen the democratization of finance. This means that people who were once shut out of the credit system could now get credit cards, mortgages or home equity loans. Another name for democratization of finance is "subprime credit." Congress previously praised the growth of the "ownership society" and but are now horrified at the implications of predatory lending and subprime credit practices. We have to consider the benefits and costs of credit democratization.
- **Investment Banking Funding Mismatches** - Investment Banks (as well as SIVs and ABCP conduits) funded huge positions in relatively illiquid long dated assets with short term funding, such as overnight repo. When the market loses confidence in a counterparty, short term funding evaporates. In this situation, no amount of capital can stop an institution from failing. The financial reform legislation does not address this major structural issue.

The above is not to absolve derivatives nor the derivatives community from their blame for the crisis. Certainly, more transparency and reporting, is important; capital requirements for many types of derivatives was too low; some type of central clearing mechanism with daily margin is useful to reduce systemic risk. Also we must address the leverage imbedded in derivatives and the way in which derivatives can exacerbate systemic risk. However, demonizing the financial industry (or using S&M as the hook for a story on a substantive industry conference) is unhelpful and trivializes the significant thought and work that must be done to improve the financial system and make the world economy safer.