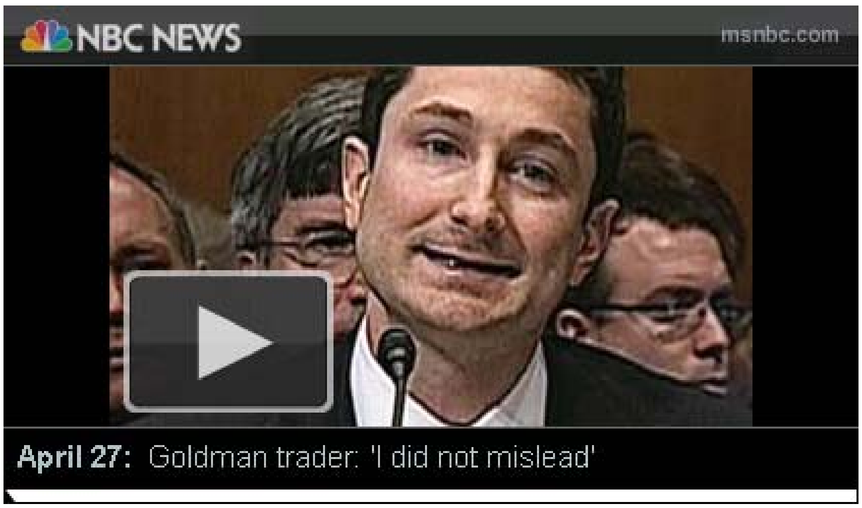
ROOM FOR DEBATE A Running Commentary on the News

April 27, 2010, *7:38 pm*

Do C.D.O.'s Have Social Value?

By THE EDITORS



A Senate panel on Tuesday grilled current and former executives at Goldman Sachs about their aggressive marketing of mortgage-based investments and then betting against those investments. Early this month, the Securities and Exchange Commission filed a lawsuit charging the bank with fraud for creating and selling mortgage-backed securities that were intended to fail.

At the center of that case are synthetic collateralized debt obligations, complex financial instruments which many say played a big role in making the financial crisis worse by providing more securities to bet against. How do we regulate or restrict new Wall Street creations, like synthetic C.D.O.'s, without squelching innovations that might enhance market efficiency?

- Frank Partnoy, law professor and author of "F.I.A.S.C.O."
- Arnold Kling, EconLog
- James Kwak, co-author, "13 Bankers"

Instruments of Destruction

*[**Frank Partnoy**](#) is a professor of law and finance and the director of the Center on Corporate and Securities Law at the University of San Diego. He is the author of "F.I.A.S.C.O.," "Infectious Greed," and most recently,"The Match King: The Financial Genius behind a Century of Wall Street Scandals." His recent presentation on off-balance sheet transactions [is available here](#).*

The main lesson here is that financial innovation is dangerous and often of no social value. This lesson might seem new, but it's not.

> C.D.O.'s have little or no social value — and they aren't new.

Historically, financial innovation has been central to every major crisis, going back to the 1920s, and especially since the 1980s. Remember Bankers Trust or Salomon Brothers or Orange County or Kidder Peabody or Long-Term Capital Management or Enron?

Financial innovation, particularly the abuse of derivatives, was at the core of each of these disasters, just as it is today. Unlike other forms of business innovation, which are directed at creating new products and services, the focus of financial innovation has been to avoid regulation, to enable institutions to take risks they should not take or do not understand, to take advantage of false and fraudulent credit ratings, and to manipulate results for tax or accounting purposes. Those are not productive forms of innovation.

Synthetic collateralized debt obligations, the product regulators are now scrutinizing, are a typical example. They are dangerous and of little or no social value. But they aren't new. Fred Carr of Drexel Burnham Lambert, Michael Milken's former firm, created early versions of C.D.O.'s during the 1980s, and the synthetic form of the C.D.O. — in which there are no actual assets, only derivatives referring to assets — was big business more than a decade ago.

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Innovations Aren't the Problem

*[**Arnold Kling**](#) is an adjunct scholar with the Cato Institute and a member of the Financial Markets Working Group of the Mercatus Center at George Mason University. He is the author of "Unchecked and Unbalanced: How the Discrepancy Between Knowledge and Power Caused the Financial Crisis and Threatens Democracy." He writes for [Econlog](#).*

New financial instruments played a role in the financial crisis. However, attempting to regulate such innovation is not the most promising approach for preventing crises in the future.

> Rather than acting as a brake, regulators were swept up in the latest euphoria.

In the housing market in the United States (and in many other countries as well), the period from roughly 2000 through 2006 was one of financial euphoria. As John Kenneth Galbraith pointed out in 1990 in his book, "A Short History of Financial Euphoria," such periods tend to foster innovations that at the time seem more magical than is in fact the case.

Rather than acting as a brake, regulators were swept up in the latest euphoria. [In a speech](#) that he gave in June 2006, Federal Reserve Chairman Ben Bernanke said:

> Banks and other market participants have made many of the key innovations in risk measurement and risk management, but supervisors have often helped to adapt and disseminate best practices to a broader array of financial institutions.

As it turns out, much of the financial innovation of recent years was designed to minimize the effect of regulatory requirements on bank capital. This "regulatory capital arbitrage," as it was termed by both regulators and market participants, drove much of Wall Street's innovations of the past 10 years.

Close

Under the international capital standards known as the Basel Accords, particularly rules implemented in 2001, AAA-rated securities were granted exalted status, stimulating the creation of AAA-rated securities out of lower-quality assets, such as sub-prime mortgages.

Usually, markets perform well at sorting out innovation. Innovations that are socially beneficial earn sustainable profits, while innovations that provide no social benefit fall by the wayside.

However, markets did not perform well during the recent euphoria. First, many of the innovations were profitable not because they added social value but because they exploited regulatory anomalies. Second, the companies that lost money on these innovations were not allowed to fall by the wayside — instead, they were bailed out.

Many pundits claim that we allowed the financial system to be self-regulating during the euphoria. This is emphatically not the case. Without the anomalies created by the Basel capital regulations, the financial system would not have rewarded these innovations.

In a self-regulating system, investors who held debt in Freddie Mac, Fannie Mae, or large banks would have put pressure on those companies to rein in their risk-taking, rather than counting on bailouts.

Some day, we are bound to experience another episode of financial euphoria with its own innovations, and in that environment regulators are likely to be just as unable to foresee the consequences. Instead of putting our faith in regulation to provide a fool-proof financial system, we should be focusing on two things.

One is to phase out Fannie Mae, Freddie Mac, FHA, and other agencies and policies that promote excessive debt finance for housing.

The other is to put more burden on the private sector to bear the cost of the failure of financial institutions. I recommend breaking the 10 largest financial institutions into about 40, and I also recommend trying to clarify the order in which creditors will be paid off in the event of a bank failure.

Beneficial Proof

***James Kwak** is the co-author of "13 Bankers: The Wall Street Takeover and the Next Financial Meltdown" and the economics blog The Baseline Scenario.*

The standard rationale for financial innovations is that they promote the efficient allocation of capital. This argument is tenuous when it comes to synthetic collateralized debt obligations (C.D.O.'s), which are composed of zero-sum derivatives transactions (credit default swaps, or C.D.S.); these side bets do not directly allocate capital. Side bets can enable price discovery, but synthetic C.D.O.'s live in the over-the-counter market, where prices are not transparent. It is hard to see how highly illiquid synthetic C.D.O.'s make their underlying securities significantly more liquid.

> If a transaction is too complicated to be standardized and made transparent, it shouldn't be traded at all.

While the benefits of synthetic C.D.O.'s are hard to discern, their costs are obvious. They have significant transaction costs, which means they transfer money from investors to derivatives dealers. In addition, they magnify economic risks by amplifying shocks to the financial system in unpredictable ways.

So, like Paul Krugman, I would like to see synthetic C.D.O.'s go away. But simply banning transactions like Abacus would leave the banks free to invent new variations on the same theme. An alternative would be to ban naked C.D.S. (transactions where one party buys insurance against default on some bond that it does not own) altogether. But this would outlaw some legitimate business uses of naked C.D.S.

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1.
Hassan Azarm
NY
April 27th, 2010
11:02 pm

The real issue is not whether if the CDOs are a good vehicle to raise capital for any class of assets, it is rather the quality of the individual mortgages/loans that are included in the CDOs....

CDOs should be targeted for "secured" small loans that would allow the lending institutions to raise capital on mass and reduce their borrowing costs....

It should not however act as an outlet for the lenders to dump their non-performing loans into a CDO and have someone else hold the bag...

It should be tightly regulated and its percentage of the overall loans of the lender should not exceed 25% of their loan portfolio and that the lenders ought to have 10-15% skin in the game by holding a portion of each CDO on their books.

The Insurance on the CDOs should only be issued to the owners/buyers after the CDO is placed and should be an integral part of the closing documents and be manged by an independent Trustee.

No other party other than the owners of the CDO should be allowed to buy insurance for any CDO and the Synthetic CDOs should be outlawed.

As for taking Short positions on the subject CDOs, the industry needs to come up with clear arguments on why it would be a value added exerciee for the overall financial markets and that if permitted, it must trade on a regulated exchange for price discovery and other related matters.
Recommend Recommended by 11 Readers

2.
R. Law
Texas
April 27th, 2010
11:02 pm
Manifestly, the primary social value of CDO's is to be an example of what Las Vegas is not allowed to traffic, and why state laws prohibit them:

http://www.huffingtonpost.com...

Unfortunately, the states were prevented by Congress from pursuing the dice rolls.

CDO's would be totally un-needed were it not for the un-parallelled wealth concentration at the tippy-top of the income ladder, where too few people have too much money to spend productively, and have become enamored of CDO gambling, reminding us of the Duke brothers in the movie ' Trading Places '.

The difference of course being the Duke brothers built their firm themselves and were wiped out when their bets went bad instead of heading a public firm and fleeing to the protection of federal banking charters - they lived by the sword and died by the sword, instead of dragging everyone else into their soured bets.
Recommend Recommended by 21 Readers

3.
3boysmountainmom
USA
April 27th, 2010
11:02 pm

These hearings are nothing more than a calculated move by the Democrats to push public opinion toward their legislation without having to tell us what's in it. After all Obama didn't have any problem with Goldman Sachs when they were contributing a million to his campaign did he?
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4.
Daver
New York
April 27th, 2010
11:02 pm
The problem isn't CDOs or (to use structures that would have been named pre-2007) inverse floaters, IO/POs, interest rate swaps, etc etc. They're just tools and all transfer risk. Risk transfer (from natural concentrations to end investors) is the entire point of a financial system. That's not the issue. The issue is "too big to fail." Confusing the product *this time* with the principle that matters is a mistake everyone is making right now.
Recommend Recommended by 9 Readers
5.
jc realnews
FLORIDA
April 27th, 2010
11:02 pm
Are they joking............. another flim flam.... could this be true..?
A top Treasury Department official helping craft financial overhaul legislation is facing questions about his involvement in the subprime mortgage crisis. Conservative media outlets are looking at Eric Stein's work as a senior vice president for the Center for Responsible Lending.

The organization helped get loans to people with less-than-perfect credit. It was also partially funded by billionaire John Paulson, who is currently answering questions regarding what involvement he had in the Goldman Sachs dealings.

Stein is said to be in line to head a new consumer financial protection agency if financial overhaul legislation is passed. BigGovernment.com writes under the headline of "Eric Stein Must Resign: rather than being promoted to protect consumers — he needs to explain his role in creating and sustaining the crisis."

The White House has not responded to our request for comment.

Recommend Recommended by 4 Readers
6.
pariahscary
Los Angeles, CA
April 27th, 2010
11:03 pm
I agree, especially with Frank Partnoy's observation that these "synthetic" derivatives focus on avoiding regulation, thus are not productive forms of innovation. However, these "innovations" aren't so much the issue with Goldman–Sachs. The problem is not just the conflict of interest in shorting funds they're selling, but on top of that using taxpayer money, courtesy of their revolving-door Washington access, to leverage their capital in a time when others have to sell off assets (which could be good investments, thus become bargains when are sold low to pay off margin calls, etc.).
Recommend Recommended by 12 Readers
7.

Rocky
California
April 27th, 2010
11:03 pm
Are you confusing collateralized debt obligations with credit default swaps? CDO's have a social value if they are put together using proper underwriting standards. All too often in the years leading up to the crash, good underwriting standards were not used. CDS's were often a way to engage in legalized gambling on Wall St., especially when purchased by hedge fund operators who had no economic interest in the underlying securities. But the Federal government deserves a big portion of the blame for encouraging risky loans (low down payments) to unqualified buyers. FHA is still offering 3.5% down payment loans for expensive condos in San Francisco. 3.5% down won't even cover all of the fees involved in the transaction. Has the government learned nothing from the mistakes of the past few years? If the buyer cannot come up with a down payment of at least 10% + fees, we are asking for trouble. 20% used to be the traditional down payment requirement.
Recommend Recommended by 10 Readers
8.
ANetliner
Washington, DC area
April 28th, 2010
9:36 am
I endorse James Kwak's proposals: ban naked CDS (credit default swap) trades unless a nonfinancial party can demonstrate that the transaction in question serves a legitimate business purpose, and restrict most derivative trades to an exchange. This would serve to ban synthetic CDOs (collateralized debt obligations).

Synthetic CDOs and naked CDS are no more than unproductive side bets on economic activity. Raising and allocating investment capital is important business that should be handled by Wall Street. Betting should be restricted to casinos (which, as of 2010, are often better regulated than American securities markets).

To allow Wall Street to sponsor thinly-disguised gambling sucks capital out of the investment economy into the bet economy. Want investment for businesses, home mortgages, student and consumer loans? Keep capital in the real economy and don't let it dissipate into the bet economy.

Message to the U.S. Congress: do the economy and U.S. taxpayers a favor, and rescue Wall Street from the gaming industry. Eliminate naked CDS and synthetic CDOs.
Recommend Recommended by 10 Readers
9.
BobK
OKC
April 28th, 2010
9:36 am
Do C.D.O.'s Have Social Value? None whatsoever...

I am reminded of c. 1950 Warner Brothers Cartoons...fast forward to 2010:

Pepe Le Pew: (Fabulousse Tourre): "Zis iez Nozing: Iz No Nozting!"

Daffy Duck: (Sparks): "What was that again? Hey What's up Doc !"

Tweetee Bird: (All the Rest of the Goldman Sacks Hacks): I Taught I Sahw a Puddy Kat!!!"

Porky PIg: (Blankfein): Ab ada ab ada...Aba Da,,,uhm...That's All Doc!"

Unbelievable: How do these crooks make 8 figure bonuses on top of 7 figure salaries when they (apparently) cannot even turn the pages in a book of stinking evidence and/or cannot / will not answer simple yes / no questions like: "Do you believe it is your responsibility to serve your clients' best interests?"

And every sentence includes the words: "I don't know."

All but the rest of us would have been fired (without severance pay or "parachutes" of any kind years ago!

What a shameless shambles they have made of our beloved USA !!!

Enjoy you extended retirements in the Hamptons (or Switzerland, or Ukrainia, or whoever will have you!) Hope never to see the likes of your kind (or S&L, Enron, MadeOff with all your savings hard work and dreams) ever again in this great country of OURS, certainly not your country.
Recommend Recommended by 5 Readers
10.
WF Tomba
MD
April 28th, 2010
9:36 am
After reading a bit about these "naked CDS" transactions, I am wondering whether the following scenario is legal and/or possible under the current securities laws:

A large but struggling domestic manufacturing company decides to buy a great load of naked credit default swaps on mortgages in the cities where its factories are located. It then closes all its plants and fires all its workers. The economic shock to the affected cities causes a localized surge in mortgage defaults, so the company wins its CDS bets and makes a killing.

Perhaps this particular scenario isn't realistic, but unless I'm missing something, the basic idea -- betting unlimited amounts of money on an economic disaster that you are actually capable of causing -- appears to be permissible, and may actually occur if people aren't aware of the possibility.
Recommend Recommended by 15 Readers
11.
swin4ort
Vancouver
April 28th, 2010
9:36 am
What is not being addressed is the question of how someone like Paulson should have invested in his analysis that indicated the imminent collapse of the housing bubble? There were innumerable ways of investing in any anticipated growth of the bubble; but not actually any simple way to invest in the opposite view. The value of synthetic derivatives it that they potentially offer a means of investing in negative assessments. A few perceptive watchers saw through the Madoff bubble. They were reduced to writing ineffectual letters which were ignored because they had no way to put their money where their mouths were. How many Madoff 'investors' would have been a lot more reluctant if they knew that there was a counterparty ready to match their positive assessment with an investment in Bernie's imminent collapse?
Recommend Recommended by 1 Readers

12.
Sceptical
U.S.
April 28th, 2010
9:36 am
Credit default insurance (let's call a spade a spade) provides a considerably better alternative to credit rating agencies.

The problem with credit rating agencies is that these institutions have no skin in the game & hide behind the First Amendment when they are wrong. As a result, these ratings are almost worthless. More importantly, as a result of these constraints, these ratings can NEVER be trusted, so this entire rating mechanism is fundamentally flawed.

If credit default insurance is traded in a relatively frictionless liquid market, the pricing of this default insurance is a far better indicator of the quality of the underlying credit than a rating agency rating can ever be. Why is this? Because those offering the insurance have skin in the game--the insurance writer has put his money where his mouth is, and because the buyer of such insurance is then in a position to be paid if the credit does default.

However, in order to ensure an orderly, liquid market, the writers of such insurance must post adequate collateral, the insurance must be written in standardized contract instruments, and these instruments must be traded on an open, neutral exchange.

The establishment of the CBOE and standardized options should be considered a model for how default insurance could be standardized, collateralized and traded.
Recommend Recommended by 6 Readers
13.
Andy Hain
Carmel, CA
April 28th, 2010
9:36 am
Actually just a typical day at an American business, where on some random days they'll decide to do whatever it takes to make their profit.

On the other hand, the outrage of politicians might be easier to believe if only they'd been honest during one of their campaigns for office.
Recommend Recommended by 0 Readers
14.
babson mba
Boston
April 28th, 2010
9:36 am
CDO's are essential, and should not HAVE to be on exchanges, because players in this space have enough capital to engage in a transaction. Plus these transactions are often customized per risk profile. Banning any of these products will give birth to others: the govt will always be 10 yrs behind the market.
The reason why most people don't understand it is because they do not need to engage in this space. Just like not everyone needs to know EXACTLY what occurs during neurosurgery.
Recommend Recommended by 0 Readers
15.
Phil M

Palo Alto, CA
April 28th, 2010
9:36 am
The dude from the Cato institute takes a libertarian attitude towards actually answering the question he is supposed to deal with.
Recommend Recommended by 0 Readers
16.
Chris
Berkeley, CA
April 28th, 2010
9:36 am
As I see it, the problem is transparency, or lack thereof. A bunch of highly paid accountants and attorneys sit in boiler rooms and think tanks concocting new strategies for making money, using extraordinarily complex financial transactions and instruments that few people would - or could - understand. They market these complex transactions to unscrupulous fund managers, who in turn lure unsuspecting investors with promises of huge financial rewards. But the whole thing is a concocted house of cards. By the way, many large corporations these days use these same types of transactions and instruments as mechanisms to reduce their tax liability and pay little or no income tax. The American people should be furious at these corrupt, greedy crooks and outraged at the convoluted schemes they employ to screw the public and pillage the national treasury.
Recommend Recommended by 2 Readers
17.
TH
New York
April 28th, 2010
9:36 am
Does it matter?

Think hard for 30 seconds, and I guarantee you can come up with have a dozen thinks created and sold in this country that have "no social value".
Recommend Recommended by 0 Readers
18.
BobK
OKC
April 28th, 2010
9:36 am
Furthermore, after more painful "testimony" from this merry band of thieves, we have to hear them "testify" that they know "nothing" about the "instruments" they designed and built to support their mega-grand-theft operations!

Well done Goldman Sachs US etc!

Just return 10% of your so called "earnings" for the past 20 years to each and every "investor" (nor to mention tax payer and/or citizen just trying to stay even) and maybe we may be able to stay even...

Criminal proceedings in order!

(Whatever happened to Milliken? and Boskey??? and Madeoff?)

All is Forgotten and Forgiven on WALL STREET!

Rubbish!!!
Recommend Recommended by 1 Readers
19.
S. Carroll
Victoria, BC
April 28th, 2010
9:36 am
The real question is, what is it about the uneven structure of the global economy that generates so much demand for these types of arbitrage instruments? Why is it that so much capital, particularly in the advanced economies has flowed into the non-productive financial sector? Often the assumption is that a rotten financial sector spread a noxious virus to a perfectly healthy 'main street'. However, what if the financial crisis was really a symptom of an underlying crisis in the 'real' economy?

Recommend Recommended by 6 Readers
20.
moonwell23
Albany, NY
April 28th, 2010
11:40 am
Even (perhaps particularly) "experts" are not capable of truly evaluating risk. $100,000 on a sure thing to show at the track seems to produce a fourth place finish for a horse that has won six in a row, Earthquakes and hurricanes just won't happen on schedule. More important, young hot shots who weren't even around for the mini-crash of Oct '87 are charged with huge sums and told to outperform the market. The problem appears to be that those whose formula and resources might justify CDOs are too smart to buy them and smart enough to sell them. "Behind every 'buy' there is a 'sell' -- screaming to get out".
Recommend Recommended by 1 Readers
21.
Jim Demers
New York, NY
April 28th, 2010
11:40 am
Mr. Kling falls down spectacularly with this howler: "Innovations that are socially beneficial earn sustainable profits, while innovations that provide no social benefit fall by the wayside." To call this wishful thinking is an act of extreme generosity.

It is abundantly clear that in reality, the creation of synthetic CDOs by Wall Street's wizards actually succeeded in divorcing profits from social benefit. The fraudulent conversion of unratable garbage into AAA "investments" was fabulously profitable (as the alchemists of old knew it would be), but Mr. Kling has his work cut out for him in identifying the "social benefit" of gilding lead bricks and passing them off as gold.
Recommend Recommended by 4 Readers
22.
anthoNY COWELL, ESQ.
trenton, nj
April 28th, 2010
11:40 am
That's an easy question, and the answer is no. CDOs have no social value. CDOs are simply another way to transfer wealth from one entity to Wall Street and a select few investors with inside information. These select

investors, in conjunction with investment banks, engineer massive wealth transfers, always to the detriment of the investors on the other side of the transaction.

As I think of the sacrifices of our fathers and mothers, including military service and shared sacrifice that made a dignified life possible (think social security, government insured home mortgages, the GI bill, Medicare), and as I contemplate the value of real, meaningful work, it's clear to me that these investment vehicles represent the worst examples of fraud and double dealing possible.

To think that I, as a taxpayer, bailed out Goldman Sachs, makes me sick. Other banks were permitted to fail; Chrysler was allowed to fail; Enron imploded and was indicted. There's no question in my mind that GS, and its principals, should be indicted. GS should be wound up and sold for the benefit of the American taxpayer.
Recommend Recommended by 4 Readers
23.
Technic Ally
Toronto
April 28th, 2010
11:40 am

Tax the companies at rates that at least put a much larger amount of their profits back in the taxpayers' hands.

Blankfein thinks he was doing God's work.

Like the diddling men in robes at the Vatican think they were doing.
Recommend Recommended by 0 Readers
24.
flan
Randolph, NJ
April 28th, 2010
11:40 am
Synthetic CDOs satisfied investors appetite for subprime mortgage investments without actually having to place more subprime loans into the marketplace.

There may have been more pressure to extend more credit into the actual marketplace without them. This would have been much more disastrous to the economy.
Recommend Recommended by 1 Readers
25.
Mike
Northeast USA
April 28th, 2010
11:41 am
The problem is not the CDO's but the freud and deception which was used by the crooks at Goldman to deceive the public and investors to make a kill. This is criminal. These crooks should spend some time in jail for it. At this stage I am so
outraged I do not mind to see Goldman is put out of business for good. Any business willfully deceives its clients in this land does not desreve to exist.
Recommend Recommended by 0 Readers
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