Here Today, Gone Tomorrow: How Credit Default Swaps Destroyed Over $2 Trillion In American Retirement Savings

What Happened? Will It Happen Again?

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SUMMARY

DERIVATIVE: *A derivative is a risk transfer agreement, the value of which is derived from the value of an underlying asset.*

Credit default swap: A contract that is a risk transfer agreement, the value of which is not derived from an underlying asset. The value is subjective.

A former derivatives credit analyst at U.S. Bank shares a quest to have politicians, journalists and money managers protect American's retirement savings before the 2008 stock market crash. Why wouldn't anyone listen or speak out?

Our stock markets and retirement funds collapsed, the economy careened into recession, and unemployment soared to double digits because major institutions gorged themselves on Credit Default Swaps.

Derivatives have been used for many years as conservative hedging vehicles on both regulated exchanges and over-the-counter markets. They are valuable for effecting transactions to protect losses in normal business transactions.

These contracts caused the financial systems to teeter on the brink of collapse because major institutions bet the farm without regard to managing counter-party credit risk.

There is a small irony, that as Minnesotan's we may be proud of. It relates to the 1980's, when derivatives began, when I was first learning how to analyze the credit risk of swaps. Yes, art does imitate life.

However, to start, just what is an OTC derivative?

So what is a derivative? The International Swaps Dealer Association defines it as a risk transfer agreement, the value of which is derived from the value of an underlying asset.

Let's assume you are a small importer of hand-made clay tiles from Mexico. You are going to pay the Mexican company for these tiles this June in pesos. You cannot afford the risk that come June the Mexican Peso will appreciate against the U.S. dollar. So you go to U.S. Bank and enter into a contract, a derivative. You sell your dollars to the bank, in exchange for Mexican Pesos for June settlement. You lock in the rate you pay for those pesos today in a derivative contract.

In this transaction, there are two types of risk that U.S. Bank has taken on. U.S. Bank has counter-party risk, as do you. What if in June, you have gone bankrupt and you cannot pay for the pesos? U.S. Bank would look at your import company's balance sheet before deciding whether to do this contract with you or to take the cash up front.

U. S. Bank also has the risk of what will the price of the pesos be in June. U.S. Bank has currency risk. It can chose to by the pesos now, for delivery in June and make a profit on the trade, before it quotes you a price, or it can do "proprietary trading" and have a new position, "short pesos."

Derivatives have been used for many years as conservative hedging vehicles on both regulated exchanges and over-the-counter markets.

Conversely, credit default swaps[1], are a new "derivative" established by J. P. Morgan in the early 1990's. They are used by entities to hedge against an "adverse credit event" of a corporation.

We will explore why credit default swaps should be banned. As you will see from the example of AIG and Goldman there is a fundamental conflict here in derivative definitions. Credit default swaps do not have an underlying asset. They do not meet the International Swap Dealers original definition of derivatives. One cannot determine the underlying price of a credit default swap to

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[1] *The International Swap Dealer's Association defines credit default swap as a credit derivative contract in which one party (protection buyer) pays an periodic fee to another party (protection seller) in return for compensation for default (or similar credit event) by a reference entity. The reference entity is not a party to the credit default swap. It is not necessary for the protection buyer to suffer an actual loss to be eligible for compensation if a credit event occurs.*

ensure fair trade, since there is no underlying asset.

Let’s go back in history…

Minneapolis Star Tribune – October 1988

“FBS set off a small bomb in the financial community when it revealed its $8 billion portfolio of U. S. Treasury bonds and other securities was $640 million in the red.

“A number of Wall Street’s most prestigious firms have turned against the bank, some with a vengeance. For example, in a burst of gunfire rare in the normally placid Wall Street commentary, Thomas Hanley of Salomon Brothers wrote:

“… We are disturbed by the company’s inability or unwillingness to adequately manage the credit and interest rate risks inherent in the banking industry…Because management has clearly demonstrated that it is immune to the creation of shareholder value, we believe that investors should dispose of their current positions in First Bank System.”

“Some people wonder whether First Bank is in the business of making loans or managing a leveraged bond portfolio,” said one Minneapolis Money Manager, **“It raises the question of what’s best for the community.”**

This was not banking…

In the 1980’s at U.S. Bank, hours were spent analyzing the credit risk, the counter-party credit risk, the balance sheets of those banks or corporations that we, as U. S. Bank, with whom we would enter into with over-the-counter derivative contracts.

Sitting outside the U.S Bank’s Credit Committee Conference Room, in fear, I waited my turn to be called to present ”my credit”

before the Executive Credit Committee of U.S. Bank. Hands growing cold and sweaty, as the only woman at the Bank who had the responsibility for going before the tough Head of the Executive Credit Committee, on these new-fangled things, interest rate swaps.

Once called to present, I would move to my position at the end of a long-mahogany table, alone, facing eight First Bank executives who would fire question after question at me about why this bank or corporation was entitled to this amount of credit risk. "Just exactly what are these things and why should we be involved in these interest rate swaps." We then went through what the credit risks were of these OTC contracts, how swaps worked and why it was prudent to do these derivatives with a certain bank or corporation. U.S. Bank had detailed risk management policies for all derivatives, by employee and by legal entity.

For the bank's credit executives, a banker would summarize the total amount of credit exposure U. S Bank had to say Cargill or Deutsche Bank. If the corporation or Bank were to fail, what would our losses be? What amount of counterparty exposure is prudent to have given all credit and economic factors?

We were responsible for ensuring accuracy in the voluminous detailed records of all credit exposures, on-balance sheet or off-balance sheet for all clients.

It was always assumed, there were economic, credit, business risk, country risk or currency risk that could occur. One always exercised prudence and looked at each of these and the entity on a regular basis.

While I was diligently evaluating counter-party credit risk on swaps, our CEO, Dennis Evans, was stretching the limit on how far commercial banks could take on interest rate risk, and was

investing in an art experiment, exposing us, as employees, to an incredible environment filled with contemporary art throughout our hall-ways.

ArtWork Place of New York's Village Voice, 1990

"FBS's art program began in 1981 as a way to shape a new corporate identity. Envisioning FBS as a "super-regional" bank offering all the latest banking services that deregulation would permit, FBS official Dennis Evans hired Minneapolis-based art consultant Lynne Sowder to acquire a contemporary collection that would function as an emblem of the fast-changing world of banking and an organizational development tool.

Like deregulation and $50-million paintings, corporate art programs are a product of the 1980s. More than a thousand sprang up during the greed-and-glitter decade, and among these vehicles for corporate self-promotion First Bank System's stood out. The most ambitious model of art/life interaction ever instituted in a large-scale workplace, the Minneapolis-based bank's art program has been described by New Museum of Contemporary Art director Marcia Tucker as "absolutely unique, a paradigm for many museums."

On January 1, 1989 First Bank System's art program ended abruptly.

A critically important experiment has been terminated. But what's at stake here is less a question of good guys and bad guys than a matter of power and symbols—and their frequently weird conjunction. Corporations' art-related activities may vary from amassing collections to sponsoring museum-organized exhibitions, but the purpose and meaning of such endeavors are always symbolic."

My CEO, Dennis Evans, snookered me. All those hours of studying balance sheets, surrounded by confusing contemporary art and going out on a limb as to why we as bankers should take on counter-party credit risk with Societe Generale and all those butterflies in my stomach before taking my stand before the growly head of U.S. Bank's credit committee, were for naught. How did Dennis Evans, our CEO, obtain unlimited trading risk authority, while I was sitting studying balance sheets and analyzing counter-party credit risk?

Did First Bank System's Board of Directors learn from the art experiment and from the losses resulting from excessive risk taking? Why did First Bank System appear more prudent in the recent collapse? Not having any inside information, one can look at the facts and make strong assumptions. Art does imitate life.

Why Did U.S. Bank Represent Bank CEO's Outside The White House Just Last December?

As quoted in the ***Minneapolis Star Tribune*** above U.S Bank's management was called to task in 1988, following uncontrolled risk taking. The Salomon Brother's Analyst shamed them! Journalists were not afraid to criticize management and speak of shareholder value and broader community purpose. The journalists made a difference. The equity analysts made a difference.

That time is long since past.

However, we know that U.S. Bank in the late 80's put in place at the Board level, prudent risk management policies and procedures, that limited risk taking in derivatives and any form of "rogue speculation."

Richard Davis, CEO, U.S. Bank stood outside the White House doors last December and represented these large banks responsible

for the collapse. He now serves as the new chairman of a powerful industry lobbying group, the Financial Services Roundtable, based in the nation's capital, his views will inform the debate in Washington on financial regulatory reform.

My First Awareness of Derivative Danger or… "There was Clearly Something Rotten In Denmark"

April 18, 2007, **NY Times** columnist Floyd Norris had a post, "A Warning on Derivatives." He quoted Jean-Claude Tichet, president of the European Central Bank who was speaking to the International Swap Dealers Association:

"The complex interaction between cash instruments and credit derivatives has made it increasingly difficult to monitor where different, possibly sizable positions are taken and where risks are concentrated."

If the major players did not know where the "risks were concentrated" one did not have a viable financial system. These risks were also in a credit default swap market of $34.5 trillion, at the end of 2006.

I started to dig and investigate, were these counter-party risks really not being managed? I soon learned they were not.

The Banks were entering into derivative contracts, just taking one side to the trade. They were speculating on a massive scale. I had dreamed of doing that as an investor when I first learned the ins and outs of derivatives. Take one side to a swap that you think is a pretty good bet and take in the monthly premiums. It was an irresistible trade. Free money.

Here is a simplified example. I don't believe Minnesota stalwart 3M is ever going to collapse. By entering into one side to the

credit default swap contract in 2005, I protect you from the risks of holding a 3M bond in the event 3M goes bankrupt.

You pay me a monthly premium and I guarantee to you that I will pay you the amount of the bond if 3M goes into bankruptcy. Being so sure on this bet, I enter into these contracts with everyone in the country that holds a 3M bond. I will be a millionaire, many times over. Who would not do this?

3M probably will never collapse, but there always exists an element of risk. They might. I must be prudent and make sure I can make good on my contract to you. It would be fraudulent to pretend that I had the capacity to make good on my contract with you, by insuring every 3M bondholder in the country. I do not have the capital to support all 3M bondholders in the U.S. in the event of a default.

You also must exercise prudence in entering into this contract with me. What do my financial statements say? It is your responsibility to ascertain if I can make good on my contract.

Assume I did these credit default swap contracts in 2005 with you. 3M is a good solid firm. It is now 2010. I am just fine; it was a reasonable, astute risk. What is wrong with that trade?

AIG and Goldman did the trades I always dreamed of doing. AIG wrote credit default swap contract on mortgages, some real, some synthetic. They took in premiums after premiums, without accounting for risk. Assets could lose their value. They took on counter-party credit risk way beyond their ability to fund the payouts, in the event economic conditions were to change. It was easy money. Was it complicated? Were the risks so obfuscated that the AIG Board did not understand? No, as you can see, it was common sense.

I had been well trained at U.S. Bank in counter-party risk and fraud. Once I saw the AIG house of cards I began a quest to alert others to the impending collapse and the effect it would have on our stock markets.

Grassroots Politics

February 5, 2008 at my Precinct Caucus in Minnesota I was elected a delegate and then attended the March 15, 2008 Congressional District Convention.

Speaking about the potential collapse of our banking system, I set-up a sub-caucus for delegates to join me to get the potential collapse of the U.S. Banking system on the Democratic Agenda. Education, healthcare and Iraq initiatives were irrelevant if there was a collapse of the U.S. Financial System and the destruction of our jobs, economy and stock markets. There definitely wasn't any interest at the State level on my "sub-caucus on the collapse of the financial markets."

The positive of this was I did have the opportunity to meet Nancy Pelosi at a fundraiser for our 3rd Congressional District Candidate to inquire about credit default swaps. I went up to Nancy after she spoke. I expressed my concerns over the lack of action by Congress over credit default swaps. She told me to contact Minnesota Congressman Collin Peterson.

Will the Money Managers Listen?

March 7, 2008

For my own retirement portfolio, I sold equity profits and put them into FDIC insured CD's at 5% for five years to ride out the storm.

The risks were too great and the upside was clearly limited at this point.

It was time to try to protect others in retirement from the impending collapse of the stock market. Years ago I had been in Wealth Management and my resume was in Charles Schwab's database. They sent me an email in March 2008, asking if I would be interested in looking at a position with them in Alternative Investments, derivatives.

At that point I sent an email to Schwab to relay my concerns about the very likely collapse of the equity markets due to unchecked counter-party credit risk. I stressed the need that retirees' accounts should be moved to cash to preserve principal given the high risk of a banking collapse.

Charles Schwab, San Francisco, did not respond.

Charles Schwab currently has a website where they are honoring all the retirees going back to work, who have lost their retirement funds and are now back doing what American's do best, "Pull your self up by your boot straps." The only thing wrong with this picture is they did not have to lose these retirement funds and go back to work.

Charles Schwab's Chartered Financial Analyst's could have exercised their ethical and fiduciary duty and told their retirement clients, "The markets are exceedingly volatile. These are unprecedented conditions. Let's be conservative and save your principal and ride out the storm. Charles Schwab would have made less money if they had taken that route.

Charles Schwab was certainly not alone. It was the bulk of money managers. Money management is more than throw a certain percent of your money into stocks, with a diversified portfolio

based on the latest asset allocation model, thinking the market will always go up over the long haul.

***Bloomberg* News** reported on February 18*, "U.S. states must contend with a more than $1 trillion gap between what they have saved and what they have promised to retired workers for pension and health-care benefits, the Pew Center on the States said in a report today. The Washington-based group expects the deficit to grow because of investment losses states sustained in the second half of 2008, the report said."*

The Fourth Estate

Having read the rave reviews in late 2007 by all the nation's top journalism schools on the new model and savior for the newspaper industry, *MinnPos*t, I assumed they would listen to a story about the pending collapse of our financial system. It has a local angle; it needs to be explained in plain English, so one can understand their democratic choices and contact their Congressmen to take action.

The day after Bear Stearns collapsed *MinnPost* had an article, March 18, 2008 on the Bear Stearns collapse. *MinnPost* quoted Phil Grodnick, MPMG's chief executive officer; who argued that generally, financial stocks are too heavily burdened with debt.

"We don't like the way they've been doing their business," he said. "We're not comfortable with it." But beyond those companies, "the market is in better shape than many people think," he said. That was the end of the story!

I immediately emailed *MinnPost***,** offering to help them break this story, by explaining counter-party credit risk and derivatives, to help the average retirement investor, move into cash to ride out the storm. *MinnPost* never responded and never contacted me to ask what I was so concerned about it.

Getting no response from Joel Kramer, *MinnPost* publisher, on my email, I commented on this March 18 *MinnPost* article on April 3, 2008:

"Where are the politicians and journalists? Jamie Dimon testified today in front of the Senate about the Bear Stearns purchase. This should be the issue of the Minnesota Senate campaign...the banking crisis, weak dollar and impact on our economy. What should be done?

Gretchen Morgenson of the NY Times started talking about the implication of credit default swaps and uncontrolled counter-party risk in February. The Wall Street Journal had the first mention of this house of cards (credit default swaps) this week."

Politicians and journalists had no interest in exploring anything but the most obvious "front burner" issues, health care, Iraq, jobs. They are afraid to speak up or to take a stand on an issue. It is too risky.

In February 2009 I published a "Community Voice" in *MinnPost* hoping to get Minnesotans involved in taking a stand on the derivative issue and to bring support to Minnesotan Congressman Collin Peterson, an accountant by training, who was leading a lonely charge in Congress to regulate derivatives. Congressman Peterson chair of the House Agriculture Services Committee well understood the appropriate use of derivatives on regulated exchanges by farmers and agricultural processors.

One short article was hardly enough to convey to the public the dangers of derivatives and the need for public involvement. *MinnPost* "policies" do not allow citizens to be published more than once a month, which prohibited timely follow-up on this critical legislation.

http://www.minnpost.com/community_voices/2009/02/04/6377/join_rep_peterson_in_solving_the_credit-default-swaps_mess

September 2008- The Credit Default Swaps Implode

You may recall, Treasury Secretary Paulson warned Congress that without $700 billion dollars, we may not have an economy tomorrow. Congress was asked to vote on the Troubled Asset Relief Plan (TARP).

I wrote and called Senator Klobuchar's Office on September 26, 2008 urging her to get more information before voting yes on the TARP[2].

"These are not valid assets. Separate the real assets from the synthetic and "toxic". Workout a plan between counterparties on the CDS that is separate from the mortgage-backed assets.

"Can't the $700 billion be used in more thoughtful ways, I wrote Senator Klobuchar before the TARP vote.

I don't have all the answers but I do have a unique perspective. Please listen to the little guy now and don't just go along with Henry Paulson and Bernanke on this."

I did not receive a phone call, email, or letter. I did receive a form response and later an invitation inviting me to a health care rally in Minneapolis, because I was an "interested constituent."

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[2] *TARP stands for Troubled Asset Relief Program, and it was created by the U.S. Treasury to help stable and strengthen the U.S. financial system by investing in U.S. financial institutions (banks) through its Capital Purchase Program.*

There was Ample Time for an Organized Unwinding of these Credit Default Swap Contracts – The Risks were Well Know In 2007

(*Please refer to the timeline on the AIG and Goldman credit default swap payments, entitled "Negotiating a Price, prepared by the New York Times")*

AIG's 2007 Annual Report disclosed a $9 billion loss in their credit default swap portfolio. This was just the beginning of the losses. Martin Feldstein, Harvard Economist, who was on the Board, knew that. He had predicted in Fall 2007 that the underlying assets, mortgages and synthetic mortgages would continue to decline over the next year close to 50%. That meant there would be ongoing sizable collateral payments.

The U.S. Inspector General of the Troubled Asset Relief Program pointed out from internal AIG Documents, that as early as July 2007, Goldman was aware of the potential for collapse of the underlying credit default swap assets that had sought protection from and began to demand collateral from AIG. In August 2008, AIG tried to unsuccessfully end its credit default swap contracts with Goldman Sachs. Goldman refused and issued a negative research report on AIG.

As mentioned above, in September 2008, Secretary Treasury Paulson warned the Executive Branch and Congress, "If you don't act now there will not be an economy tomorrow."

As one can see that threat was an idle threat made in pure self-interest. There were alternatives. Yes, an orderly reconciliation of these credit default swaps, supervised by the Federal Reserve Bank was an option, beginning in January 2008, prior to the collapse of Bear Stearns.

Henry Paulson was at Goldman Sachs when these credit default swap contracts were entered into with AIG. Secretary Paulson oversaw these taxpayer "collateral call" payments on the credit default swap contracts to AIG:

September 2008 - $85 billion loan to AIG with $7.5 billion to Goldman

October 2008 – Goldman demands another $1.3 billion in collateral calls

November 2008 – The Federal Reserve creates Maiden Lane III to hold $62 billion in AIG's mortgage deals and Goldman keeps $8.4 billion in AIG payments and is paid $5.6 billion by the Fed and Goldman continues to hold $5.5 billion in contracts on AIG's books.

In addition, Neil Barofsky, Inspector General for T.A.R.P. uncovered in his investigation a stunning revelation:

Goldman created the underlying assets that were worthless. Then they took out insurance on them.

I quote from *Bloomberg News* February 23, 2010

"The public can now see for the first time how poorly the securities performed, with losses exceeding 75 percent of their notional value in some cases. Compounding this, the document and Bloomberg data demonstrate that the banks that bought the swaps from AIG are mostly the same firms that underwrote the CDOs in the first place. "

January, 2009 Obama Is in Office

"Democrats have dominated Wall Street's fund-raising circles in recent elections. Mr. Obama himself raised millions of dollars

from employees of Goldman Sachs Group Inc., Citigroup Inc., J.P. Morgan Chase & Co. and other Wall Street firms. " --***Wall Street Journal***, February 6

On January 21, 2009 I reluctantly wrote Senator Klobuchar again on the appointment of President Obama's Treasury Secretary. We still had only one Senator from Minnesota.

In approving the appointment of Timothy Geithner, you do not have enough information to make an informed decision on a yes or no vote.

"I respectfully ask you to vote no for the appointment of Timothy Geithner, until the American people are given straightforward answers to the role credit default swaps played in "bringing down the U.S Financial system."

"The destruction of the U.S. economy and U.S. banking system, as a result of the reckless indifference towards the extreme dangers of excessive counter-party credit risk with credit default swaps by investment banks, AIG, hedge funds and U.S. commercial banks has not yet been addressed and proposed U.S. Secretary Geithner evaded this question today.

I did receive another "form" email from Senator Klobuchar.

February 2009 - Derivatives Transparency Act

February 3, 2009 I listened in on the House Agriculture Committee's Testimony on the Derivatives Transparency Act of 2009, after having submitted written testimony.

Submitted in this Act is my testimony, here is an excerpt:

In addition, there is a central issue in 2009 Derivative Transparency that must be resolved prior to finalizing this bill.

Please request that Treasury Secretary Geithner's office determine the ROI of using taxpayer dollars for contractual payments under credit default swap contracts

Shift the burden of contractual payments required under credit default swaps from the US taxpayer to the original parties to these contracts, effectively by unwinding these contracts. Unwinding swap contracts is unprecedented, but these times are unprecedented and AIG's right to enter into these contracts in the over-the-counter market, may have been fraudulent.

What struck me in these hearings was the incredible hubris of industry. Robert Pickel, representative of the International Swaps Dealers Association, had an air that business would continue as usual. He knew he had the powerful Wall Street lobby behind him. Congressman Peterson stood up against industry and reminded them of the devastation they had caused the American people. Collin Peterson stunned industry.

Having an opportunity to talk directly with Congressman Peterson after the hearing, I asked him, " There was no one at the Hearing representing the American people. Who is calling you? Who is saying anything about this fraud on behalf of the American people?

Congressman Peterson said no one has contacted me about regulation representing the American people. We understand what happened. Do you have any idea how angry the American public is going to be when they finally understand what actually happened here?"

I was alone in my conversation with Congressman Peterson because our journalists had failed, our equity analysts had failed, and our SEC had failed to adequately train SEC regulated investment advisors.

Here is a statement by Gary Gensler, chair of the CFTC, who spoke in Testimony on October 7, 2009 on the Derivatives Markets Act of 2009, which passed the House on October 15, 2009:

"One year ago, the financial system failed the American public. The financial regulatory system failed the American public. Exhibit A of these twin failures was the collapse of AIG. Every single taxpayer in this room—both the members of this committee and the audience put money into a company that most American's never even heard of. Approximately $180 billion of our tax dollars went into AIG, that is nearly $414 million per each of your Congressional Districts."

Proposed Regulatory Changes

With the recent revelation of Goldman Sach's role in Greece with a customized currency swap, that violated the European Union's debt limits, it is now evident all derivatives must have transparency and trade on regulated exchanges. I have changed my views since my written testimony of February 2009 to the Derivatives Transparency Act.

Here is Simon Johnson's, MIT Economist and formerly with the IMF, statement on his blog, 2/15/10, regarding Goldman and the Greek tragedy:

To allow the current government-backed (massive) Goldman to behave recklessly and with complete disregard to the basic tenets of international financial stability is utterly indefensible."

The Volker Rule

On 1/23/10 Gretchen Morgenson of the ***NY Times*** described the proposed Volker Rule:

A main element to the plan would bar banks from making proprietary trades — using their own money to place directional market bets that are unrelated to serving customers. Another change would prevent institutions from investing their own money in hedge funds or private equity operations.

Current Proposal for a Systemic Regulator

The NY Times reported that the Senate and the Obama administration are nearing agreement on forming a council of regulators, led by the Treasury secretary, to identify systemic risk to the nation's financial system, officials said Wednesday, February 17.

Here is a viable option:

If we as a nation ban credit default swaps and ensure all derivatives trade on regulated exchanges we will not need a systemic regulator. The systemic risk resulted from the inability of banks and corporations to take the individual responsibility to prudently manage counterparty credit risk. Put all derivatives on exchanges and the systemic risk goes away.

Proposed Regulatory Changes to Protect Retirement Savings – As of now, there are none

Every American with retirement savings should have been warned of the pending collapse of the equity markets.

Advisor regulations and training are an embarrassment. The SEC needs to address these concerns in regulatory reform, immediately:

- Any money manager or broker having **any** interaction with a qualified retirement account, pension, non-profit (401k, pension, IRA, SEP) must be held to the Investment Advisors

Act of 1940 fiduciary standard. (It appears the fiduciary standard has been killed by industry and will not happen.)

- The SEC will implement strict ethical standards for the sale of product to any qualified retirement account, non-profit or pension.

"More troubling, said Christopher Whalen, editor of the Institutional Risk Analyst, is that the Volcker Rule would do nothing to solve the most disturbing problem to have emerged in the crisis: how Wall Street created flotillas of toxic securities and sold them to investors."

- New, high level training standards on financial market analysis, including commercial lending training, counter-party credit risk analysis, derivative analysis and country and currency risk assessments will be required. A two-year training program in financial analysis and markets will be mandatory for any mutual fund manager, investment advisor or broker that is to have any involvement with a retirement plan, non-profit or pension fund.

- Any SEC regulated advisor that is found guilty of any ethical or fiduciary rule violation will be immediately banned for life from the securities industry

- FINRA, the securities industry group, will be eliminated and folded into the SEC for customer disputes. The securities industry can no longer have a self-regulating organization arbitrating the disputes of retirement clients and non-profits. Congress must insure the SEC implements a non-biased resolution to retirement, non-profit, or pension securities complaints.

In sum:

1. A systemic risk regulator is not needed if credit default swaps are banned and all derivatives trade on a regulated exchange

2. A consumer financial protection agency is not as critical as fundamental changes at the SEC and FINRA about training, ethics, fiduciary responsibility and disclosures

3. The Volker rule, to limit proprietary trading at U.S. commercial banks is critical

Ironically, Richard Davis, U.S. Bank CEO as Chair of the Financial Services Roundtable supports continued use of customized credit default swaps, off regulated exchanges. In other words, Banks support the continuation of "rogue speculation", to the detriment to our society overall.

Is the income from credit default swaps how we want to build the basis of our GDP and our economy?

We know in our hearts we do not want to rebuild an economy of synthetics. We want vibrancy and creativity. We want an economy of value --Apple, IBM, Microsoft, Amazon, Google, 3M and Caterpillar. In short, we want to invest in the change that will rebuild competitiveness and a strong foundation for…well, for me, it is for my sons and their sons' or daughters' future.

Monthly contractual payments from credit default swaps do add significant income flows to our GDP, but at what cost and what value is that bringing to our society? It is only five major banks in the U.S. that do over 96% of all credit default swaps.

Credit default swaps make you lazy and what is worse, they reward poor business practices. One has insured against this risk, so no need to look at the balance sheet of that company or that country. It is a false security. If no one looks at the financials, who is managing the risk?

Credit default swaps allow rogue speculation on the collapse of banks, corporations and sovereign governments. This is destructive to the fundamentals on which our capitalist system was founded.

Foreign currencies, corn, gold and wheat all have tangible values. Credit risk does not have a derivative value. It was a flawed model. Credit risk is not an asset.

Mortgage loan securitizations that left banks with no portion of the loan on their books, lacked all accountability. Of course these loans failed, no one analyzed the credit. Credit rating agencies did not do their due diligence.

Does Any Republican or Democrat Want to Invest in the Technical Capabilities Needed to Control Systemic Risk?

Robert Engle, Professor of Finance, Stern School of Business, NYU, testified on February 10, 2010 before the Senate Banking Committee.

"I recently co‐authored a report of the National Research Council that summarized a workshop on Technical Capabilities needed for the Regulation of Systemic Risk.

The data collection and aggregation functions of the NIF proposal are staggering. In particular, the OTC contracts are the most complex and have the greatest chance of being systemic."

Congress and our private and public universities are spending hours trying to design elaborate systems to monitor all these senseless, trillions of contracts. It is exceedingly expensive to design the systems, to regulate and to monitor these credit default swap contracts.

We use to do it for free at the Bank. It was a bank's responsibility. If the credits failed, the bank was out the money. There was professionalism, a trust and a respect between the banks that were involved in the small OTC derivative market. There was an unspoken, working understanding of prudence. Trust was a handshake.

The trust is gone. Wall Street's raison d'être is the loopholes that make easy money, that seem to now be teetering on unethical behavior to fraud. No amount of money, systems and data regulation can prevent the loopholes, when there is not an underlying basis of trust.

Why didn't the Fourth Estate, Money Managers or Politicians Take Action To Prevent the Collapse?

How could one believe that Senator Klobuchar would actually take the time to respond, to engage on a citizen's ideas outside the beltway or their usual circle of advisors!

Having gone to college in the late sixties, what was I thinking? At Boston University, my alma mater, our political science professor Howard Zinn was the out-spoken, eloquent organizer to effect change. He pushed us to think critically, to don't believe "what the people up there tell you."

Just last December; I had the luck to flip on Bill Moyers. I was reminded of that sunlit morning in May 1970, the morning following the Kent State shootings of students, when National

Guardsmen escorted me to class with submachine guns on Bay State Road at Boston University.

There he was, Howard Zinn, taking about his upcoming film with Matt Damon, "*A People Speak."* It was my fault; Professor Zinn's teachings were forgotten. One cannot effect change as an island.

Professor Zinn spoke so eloquently, calmly to Bill Moyers that night:

" Don't depend on our leaders to do what needs to be done. Because whenever the government has done anything to bring about change, it's done so only because it's been pushed and prodded by social movements, by ordinary people organizing, by, you know, Lincoln pushed by the anti-slavery movement. You know, Johnson and Kennedy pushed by the southern black movement.

Traditional history creates passivity because it gives you the people at the top and it makes you think that all you have to do is go to the polls every four years…We want people to understand that that's not going to happen. People have to do it themselves. "

Professor Zinn died just last month on January 27.

It is Up to You as Professor Zinn Would Say

"I wanted students to leave my classes not just better informed, but more prepared to relinquish the safety of silence, more prepared to speak up, to act against injustice wherever they saw it.

Change can only come in a democracy from the bottom up.
A few alerted our Congressmen, our Money Managers and the Fourth Estate that our stock market would crash. They all chose to ignore these valid pleas.

It is a vicious cycle of self-interest. Washington is in a strangle hold by Wall Street. If President Obama talks about regulation, the equity markets crash. It is a game, a game of big money.

We have been lulled into a false sense of wealth. That wealth has been synthetic for the past two decades. It did not exist.
As the Salomon Brothers analyst said in the *Star Tribune* 20 years ago,

".... Because management has clearly demonstrated that it is immune to the creation of shareholder value, we believe that investors should dispose of their current positions in First Bank System."

It is just that simple. We need a public out-cry.

Based on my experience with derivatives, credit default swaps must be banned and **all** derivatives must trade on regulated exchanges. Congress has a duty to the future of our democracy to stand up for morals, ethics and to invest in America, not in trillions of dollars to baby sit the side "bets" of Wall Street with the expensive computer systems to monitor these contracts.

We all recently heard about the "Greek Tragedy." Wall Street did not create Europe's debt problem, however "bankers enabled Greece and others to borrow beyond their means, in deals that were "perfectly legal." What are bankers building?

Do you want our money directed to science, technology, education and helping others rise from poverty or to designing complex regulatory systems for monitoring trillions of derivatives that serve no purpose and add no value to our society's foundation and infrastructure? I urge you to speak for what you value for the future of our society at thederivativeproject.com.

I close with Christopher Whalen's, Managing Director, Institutional Risk Analytics, testimony to Congress in July 2009 on derivatives:

"Credit Default Swaps Violate the Basic Principle of Fairness and Fair Dealing…

Jefferson said, "That commerce between master and slave is barbarism. " All of the Founders were Greek scholars. They knew what makes nations great and what pulled them down into ruins. And they knew that above all else, how we treat ourselves, as individuals, customers, neighbors, traders and fellow citizens, matters more than just making a living. If we as a nation tolerate unfairness in our financial markets in the form of the current market for credit default swaps, then how can we expect our financial institutions to be safe and sound?"

Recommended Reading

Johnson, Simon, Kwak, James, Thirteen Bankers

On Sale March 30

A beautifully written and powerful story that ties the current financial crisis to a cycle of politics as old as the Republic, and to pathology in our politics that is as profound as any that our Republic has faced. We are far away from solving that crisis, and hopelessly far from even understanding how we could cure this pathology. Required reading for the President, and anyone else who cares for this Republic.

Lawrence Lessig, Professor of Law and Director of the
Edmond J. Safra Foundation for Ethics at Harvard University

Too many discussions of the Great Recession present it as a purely economic phenomenon–the result of excessive leverage or errors of monetary policy or algorithms run mad. Simon Johnson was the first to point out that this was and is a crisis of political economy. His and James Kwak's analysis of the unholy inter-twining of Washington and Wall Street–a cross between the gilded age and a banana republic – is essential reading.

Niall Ferguson, Professor of History at Harvard University,
Professor at Harvard Business School, and Author of *The Ascent of Money*

Morris, Charles, The Two Trillion Dollar Meltdown: Easy Money, High Rollers, and the Great Credit Crash, (2008)

Patterson, Scott, The Quants, (2010)

Stiglitz, Joseph, Freefall, (2010)

Zinn, Howard, A People's History of the United States, (1980)

Blogs

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