The New York Times
nytimes.com

October 9, 2008

THE RECKONING

Taking Hard New Look at a Greenspan Legacy

By PETER S. GOODMAN

“Not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient.” — Alan Greenspan in 2004

George Soros, the prominent financier, avoids using the financial contracts known as derivatives “because we don’t really understand how they work.” Felix G. Rohatyn, the investment banker who saved New York from financial catastrophe in the 1970s, described derivatives as potential “hydrogen bombs.”

And Warren E. Buffett presciently observed five years ago that derivatives were “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”

One prominent financial figure, however, has long thought otherwise. And his views held the greatest sway in debates about the regulation and use of derivatives — exotic contracts that promised to protect investors from losses, thereby stimulating riskier practices that led to the financial crisis. For more than a decade, the former Federal Reserve Chairman Alan Greenspan has fiercely objected whenever derivatives have come under scrutiny in Congress or on Wall Street. “What we have found over the years in the marketplace is that derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so,” Mr. Greenspan told the Senate Banking Committee in 2003. “We think it would be a mistake” to more deeply regulate the contracts, he added.

Today, with the world caught in an economic tempest that Mr. Greenspan recently described as “the type of wrenching financial crisis that comes along only once in a century,” his faith in derivatives remains unshaken.

The problem is not that the contracts failed, he says. Rather, the people using them got greedy. A lack of integrity spawned the crisis, he argued in a speech a week ago at Georgetown University, intimating that those peddling derivatives were not as reliable as “the pharmacist who fills the prescription ordered by our physician.”

But others hold a starkly different view of how global markets unwound, and the role that Mr. Greenspan played in setting up this unrest.

“Clearly, derivatives are a centerpiece of the crisis, and he was the leading proponent of the deregulation of derivatives,” said Frank Partnoy, a law professor at the University of San Diego and an expert on financial regulation.

The derivatives market is $531 trillion, up from $106 trillion in 2002 and a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them.

If Mr. Greenspan had acted differently during his tenure as Federal Reserve chairman from 1987 to 2006, many economists say, the current crisis might have been averted or muted.

Over the years, Mr. Greenspan helped enable an ambitious American experiment in letting market forces run free. Now, the nation is confronting the consequences.

Derivatives were created to soften — or in the argot of Wall Street, "hedge" — investment losses. For example, some of the contracts protect debt holders against losses on mortgage securities. (Their name comes from the fact that their value "derives" from underlying assets like stocks, bonds and commodities.) Many individuals own a common derivative: the insurance contract on their homes.

On a grander scale, such contracts allow financial services firms and corporations to take more complex risks that they might otherwise avoid — for example, issuing more mortgages or corporate debt. And the contracts can be traded, further limiting risk but also increasing the number of parties exposed if problems occur.

Throughout the 1990s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. In meetings with federal officials, celebrated appearances on Capitol Hill and heavily attended speeches, Mr. Greenspan banked on the good will of Wall Street to self-regulate as he fended off restrictions.

Ever since housing began to collapse, Mr. Greenspan's record has been up for revision. Economists from across the ideological spectrum have criticized his decision to let the nation's real estate market continue to boom with cheap credit, courtesy of low interest rates, rather than snuffing out price increases with higher rates. Others have criticized Mr. Greenspan for not disciplining institutions that lent indiscriminately.

But whatever history ends up saying about those decisions, Mr. Greenspan's legacy may ultimately rest on a more deeply embedded and much less scrutinized phenomenon: the spectacular boom and calamitous bust in derivatives trading.

Faith in the System

Some analysts say it is unfair to blame Mr. Greenspan because the crisis is so sprawling. "The notion that Greenspan could have generated a totally different outcome is naïve," said Robert E. Hall, an economist at the conservative Hoover Institution, a research group at Stanford.

Mr. Greenspan declined requests for an interview. His spokeswoman referred questions about his record to his memoir, "The Age of Turbulence," in which he outlines his beliefs.

"It seems superfluous to constrain trading in some of the newer derivatives and other innovative financial contracts of the past decade," Mr. Greenspan writes. "The worst have failed; investors no longer fund them and are not likely to in the future."

In his Georgetown speech, he entertained no talk of regulation, describing the financial turmoil as the failure of Wall Street to behave honorably.

“In a market system based on trust, reputation has a significant economic value,” Mr. Greenspan told the audience. “I am therefore distressed at how far we have let concerns for reputation slip in recent years.”

As the long-serving chairman of the Fed, the nation’s most powerful economic policy maker, Mr. Greenspan preached the transcendent, wealth-creating powers of the market.

A professed libertarian, he counted among his formative influences the novelist Ayn Rand, who portrayed collective power as an evil force set against the enlightened self-interest of individuals. In turn, he showed a resolute faith that those participating in financial markets would act responsibly.

An examination of more than two decades of Mr. Greenspan’s record on financial regulation and derivatives in particular reveals the degree to which he tethered the health of the nation’s economy to that faith.

As the nascent derivatives market took hold in the early 1990s, and in subsequent years, critics denounced an absence of rules forcing institutions to disclose their positions and set aside funds as a reserve against bad bets.

Time and again, Mr. Greenspan — a revered figure affectionately nicknamed the Oracle — proclaimed that risks could be handled by the markets themselves.

“Proposals to bring even minimalist regulation were basically rebuffed by Greenspan and various people in the Treasury,” recalled Alan S. Blinder, a former Federal Reserve board member and an economist at Princeton University. “I think of him as consistently cheerleading on derivatives.”

Arthur Levitt Jr., a former chairman of the Securities and Exchange Commission, says Mr. Greenspan opposes regulating derivatives because of a fundamental disdain for government.

Mr. Levitt said that Mr. Greenspan’s authority and grasp of global finance consistently persuaded less financially sophisticated lawmakers to follow his lead.

“I always felt that the titans of our legislature didn’t want to reveal their own inability to understand some of the concepts that Mr. Greenspan was setting forth,” Mr. Levitt said. “I don’t recall anyone ever saying, ‘What do you mean by that, Alan?’ ”

Still, over a long stretch of time, some did pose questions. In 1992, Edward J. Markey, a Democrat from Massachusetts who led the House subcommittee on telecommunications and finance, asked what was then the General Accounting Office to study derivatives risks.

Two years later, the office released its report, identifying “significant gaps and weaknesses” in the regulatory oversight of derivatives.

“The sudden failure or abrupt withdrawal from trading of any of these large U.S. dealers could cause liquidity problems in the markets and could also pose risks to others, including federally insured banks and the financial system as a whole,” Charles A. Bowsher, head of the accounting office, said when he testified before Mr. Markey's committee in 1994. "In some cases intervention has and could result in a financial bailout paid for or guaranteed by taxpayers."

In his testimony at the time, Mr. Greenspan was reassuring. "Risks in financial markets, including derivatives markets, are being regulated by private parties," he said.

"There is nothing involved in federal regulation per se which makes it superior to market regulation."

Mr. Greenspan warned that derivatives could amplify crises because they tied together the fortunes of many seemingly independent institutions. "The very efficiency that is involved here means that if a crisis were to occur, that that crisis is transmitted at a far faster pace and with some greater virulence," he said.

But he called that possibility "extremely remote," adding that "risk is part of life."

Later that year, Mr. Markey introduced a bill requiring greater derivatives regulation. It never passed.

Resistance to Warnings

In 1997, the Commodity Futures Trading Commission, a federal agency that regulates options and futures trading, began exploring derivatives regulation. The commission, then led by a lawyer named Brooksley E. Born, invited comments about how best to oversee certain derivatives.

Ms. Born was concerned that unfettered, opaque trading could "threaten our regulated markets or, indeed, our economy without any federal agency knowing about it," she said in Congressional testimony. She called for greater disclosure of trades and reserves to cushion against losses.

Ms. Born's views incited fierce opposition from Mr. Greenspan and Robert E. Rubin, the Treasury secretary then. Treasury lawyers concluded that merely discussing new rules threatened the derivatives market. Mr. Greenspan warned that too many rules would damage Wall Street, prompting traders to take their business overseas.

"Greenspan told Brooksley that she essentially didn't know what she was doing and she'd cause a financial crisis," said Michael Greenberger, who was a senior director at the commission. "Brooksley was this woman who was not playing tennis with these guys and not having lunch with these guys. There was a little bit of the feeling that this woman was not of Wall Street."

Ms. Born declined to comment. Mr. Rubin, now a senior executive at the banking giant Citigroup, says that he favored regulating derivatives — particularly increasing potential loss reserves — but that he saw no way of doing so while he was running the Treasury.

"All of the forces in the system were arrayed against it," he said. "The industry certainly didn't want any increase in these requirements. There was no potential for mobilizing public opinion."

Mr. Greenberger asserts that the political climate would have been different had Mr. Rubin called for regulation.

In early 1998, Mr. Rubin's deputy, Lawrence H. Summers, called Ms. Born and chastised her for taking steps he said would lead to a financial crisis, according to Mr. Greenberger. Mr. Summers said he could not recall the conversation but agreed with Mr. Greenspan and Mr. Rubin that Ms. Born's proposal was "highly problematic."

On April 21, 1998, senior federal financial regulators convened in a wood-paneled conference room at the Treasury to discuss Ms. Born's proposal. Mr. Rubin and Mr. Greenspan implored her to reconsider, according to both Mr. Greenberger and Mr. Levitt.

Ms. Born pushed ahead. On June 5, 1998, Mr. Greenspan, Mr. Rubin and Mr. Levitt called on Congress to prevent Ms. Born from acting until more senior regulators developed their own recommendations. Mr. Levitt says he now regrets that decision. Mr. Greenspan and Mr. Rubin were "joined at the hip on this," he said. "They were certainly very fiercely opposed to this and persuaded me that this would cause chaos."

Ms. Born soon gained a potent example. In the fall of 1998, the hedge fund Long Term Capital Management nearly collapsed, dragged down by disastrous bets on, among other things, derivatives. More than a dozen banks pooled $3.6 billion for a private rescue to prevent the fund from slipping into bankruptcy and endangering other firms.

Despite that event, Congress froze the Commodity Futures Trading Commission's regulatory authority for six months. The following year, Ms. Born departed.

In November 1999, senior regulators — including Mr. Greenspan and Mr. Rubin — recommended that Congress permanently strip the C.F.T.C. of regulatory authority over derivatives.

Mr. Greenspan, according to lawmakers, then used his prestige to make sure Congress followed through. "Alan was held in very high regard," said Jim Leach, an Iowa Republican who led the House Banking and Financial Services Committee at the time. "You've got an area of judgment in which members of Congress have nonexistent expertise."

As the stock market roared forward on the heels of a historic bull market, the dominant view was that the good times largely stemmed from Mr. Greenspan's steady hand at the Fed.

"You will go down as the greatest chairman in the history of the Federal Reserve Bank," declared Senator Phil Gramm, the Texas Republican who was chairman of the Senate Banking Committee when Mr. Greenspan appeared there in February 1999.

Mr. Greenspan's credentials and confidence reinforced his reputation — helping him to persuade Congress to repeal Depression-era laws that separated commercial and investment banking in order to reduce overall risk in the financial system.

"He had a way of speaking that made you think he knew exactly what he was talking about at all times," said Senator Tom Harkin, a Democrat from Iowa. "He was able to say things in a way that made people not want to question him on anything, like he knew it all. He was the Oracle, and who were you to question him?"

In 2000, Mr. Harkin asked what might happen if Congress weakened the C.F.T.C.'s authority.

"If you have this exclusion and something unforeseen happens, who does something about it?" he asked Mr. Greenspan in a hearing.

Mr. Greenspan said that Wall Street could be trusted. "There is a very fundamental trade-off of what type of economy you wish to have," he said. "You can have huge amounts of regulation and I will guarantee nothing will go wrong, but nothing will go right either," he said.

Later that year, at a Congressional hearing on the merger boom, he argued that Wall Street had tamed risk.

"Aren't you concerned with such a growing concentration of wealth that if one of these huge institutions fails that it will have a horrendous impact on the national and global economy?" asked Representative Bernard Sanders, an independent from Vermont.

"No, I'm not," Mr. Greenspan replied. "I believe that the general growth in large institutions have occurred in the context of an underlying structure of markets in which many of the larger risks are dramatically — I should say, fully — hedged."

The House overwhelmingly passed the bill that kept derivatives clear of C.F.T.C. oversight. Senator Gramm attached a rider limiting the C.F.T.C.'s authority to an 11,000-page appropriations bill. The Senate passed it. President Clinton signed it into law.

Pressing Forward

Still, savvy investors like Mr. Buffett continued to raise alarms about derivatives, as he did in 2003, in his annual letter to shareholders of his company, Berkshire Hathaway.

"Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers," he wrote. "The troubles of one could quickly infect the others."

But business continued.

And when Mr. Greenspan began to hear of a housing bubble, he dismissed the threat. Wall Street was using derivatives, he said in a 2004 speech, to share risks with other firms.

Shared risk has since evolved from a source of comfort into a virus. As the housing crisis grew and mortgages went bad, derivatives actually magnified the downturn.

The Wall Street debacle that swallowed firms like Bear Stearns and Lehman Brothers, and imperiled the insurance giant American International Group, has been driven by the fact that they and their customers were linked to one another by derivatives.

In recent months, as the financial crisis has gathered momentum, Mr. Greenspan's public appearances have become less frequent.

His memoir was released in the middle of 2007, as the disaster was unfolding, and his book tour suddenly became a referendum on his policies. When the paperback version came out this year, Mr. Greenspan wrote an epilogue that offers a rebuttal of sorts.

“Risk management can never achieve perfection,” he wrote. The villains, he wrote, were the bankers whose self-interest he had once bet upon.

“They gambled that they could keep adding to their risky positions and still sell them out before the deluge,” he wrote. “Most were wrong.”

No federal intervention was marshaled to try to stop them, but Mr. Greenspan has no regrets.

“Governments and central banks,” he wrote, “could not have altered the course of the boom.”