Statement by Christopher Whalen
Committee on Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance, and Investment
United States Senate
June 22, 2009

Chairman Reed, Senator Bunning, Members of the Committee:

Thank you for requesting my testimony today regarding the operation and regulation of over-the-counter or "OTC" derivatives markets. My name is Christopher Whalen and I live in the State of New York.[1] I work in the financial community as an analyst and a principal of a firm that rates the performance of commercial banks. I previously appeared before the full Committee in March of this year to discuss regulatory reform.

First let me make a couple of points for the Committee on how to think about OTC derivatives. Then I will answer your questions in summary form. Finally, I provide some additional sources and references to help you in your deliberations.

1) Defining OTC Asset Classes:

When you think about OTC derivatives, you must include both conventional interest rate and currency swap contracts, single name credit default swap or "CDS" contracts, and the panoply of specialized, customized gaming contracts for everything and anything else that can be described, from the weather to sports events to shifting specific types of risk exposure from one unit of AIG to another. You must also include the family of complex structured financial instruments such as mortgage securitizations and collateralized debt obligations or "CDOs," for these too are OTC "derivatives" that purport to derive their "value" from another asset or instrument.

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[1] Mr. Whalen is a co-founder of Institutional Risk Analytics, a Los Angeles unit of Lord, Whalen LLC that publishes risk ratings and provides customized financial analysis and valuation tools.

2) Bank Business Models & OTC

Perhaps the most important issue for the Committee to understand is that the structure of the OTC derivatives market today is a function of the flaws in the business models of the largest dealer banks, including JPMorgan Chase (NYSE:JPM), Bank of America (NYSE:BAC) and Goldman Sachs (NYSE:GS). These flaws are structural, have been many decades in the making, and have been concealed from the Congress by the Fed and other financial regulators.

The fact that today OTC derivatives trading is the leading source of profits and also risk for many large dealer banks should tell the Congress all that it needs to know about the areas of the markets requiring immediate reform. Many cash and other capital markets operations in these banks are marginal in terms of return on invested capital, suggesting that banks beyond a certain size are not only too risky to manage – but are net destroyers of value for shareholders and society even while pretending to be profitable.[2]

Simply stated, the supra-normal returns paid to the dealers in the closed OTC derivatives market are effectively a tax on other market participants, especially investors who trade on open, public exchanges and markets. The deliberate inefficiency of the OTC derivatives market results in a dedicated tax or subsidy meant to benefit one class of financial institutions, namely the largest OTC dealer banks, at the expense of other market participants. Every investor in the global markets pay the OTC tax via wider bid-offer spreads for OTC derivatives contracts than would apply on an organized exchange.[3]

The taxpayers in the industrial nations also pay a tax through periodic losses to the system caused by the failure of the victims of OTC derivatives and complex structured assets such as AIGs and Citigroup (NYSE:C). And most important, the regulators who are supposed to protect the taxpayer from the costs of cleaning up these periodic loss

[2] See 'Talking About RAROC: Is "Financial Innovation" Good for Bank Profitability?', *The Institutional Risk Analyst*, June 10, 2008 (http://us1.institutionalriskanalytics.com/pub/IRAstory.asp?tag=286).
[3] See 'Credit Default Swaps and Too Big to Fail or Unwind: Interview With Ed Kane', *The Institutional Risk Analyst,* June 3, 2009 (http://us1.institutionalriskanalytics.com/pub/IRAstory.asp?tag=364)

events are so captive by the very industry they are charged by law to regulate as to be entirely ineffective. <u>As the Committee proceeds in its deliberations about reforming OTC derivatives, the views of the existing financial regulatory agencies and particularly the Federal Reserve Board and Treasury, should get no consideration from the Committee since the view of these agencies are largely duplicative of the views of JPM and the large OTC dealers</u> .

3) <u>Basis Risk & Derivatives</u>:

The entire family of OTC derivatives must be divided into types of contracts for which there is a clear, visible cash market and those contracts for which the basis is obscure or non-existent. A currency or interest rate or natural gas swap OTC contract are clearly linked to the underlying cash markets or the "basis" of these derivative contracts, thus both buyers are sellers have reasonable access to price information and the transaction meets the basic test of fairness that has traditionally governed American financial regulation and consumer protection.

With CDS and more obscure types of CDOs and other complex mortgage and loan securitizations, however, the basis of the derivative is non-existent or difficult/expensive to observe and calculate, thus the creators of these instruments in the dealer community employ "models" that purport to price these derivatives. The buyer of CDS or CDOs has no access to such models and thus really has no idea whatsoever how the dealer valued the OTC derivative. More, the models employed by the dealers are almost always and uniformly wrong, and are thus completely useless to value the CDS or CDO. The results of this unfair, deceptive market are visible for all to see – and yet the large dealers, including JPM, BAC and GS continue to lobby the Congress to preserve the CDS and CDO markets in their current speculative form.[4]

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[4] For an excellent discussion of why OTC derivatives and complex structured assets are essentially a fraud, see the presentation by Ann Rutledge, "What's Great about the ETP Model?," PRMIA, June 10, 2009. (http://www.prmia.org/Chapter_Pages/Data/Files/3227_3508_PRMIA%20CDS_presentation.pdf)

In my view, CDS contracts and complex structured assets are deceptive by design and beg the question as to whether a certain level of complexity is so speculative and reckless as to violate US securities and anti-fraud laws. That is, if an OTC derivative contract lacks a clear cash basis and cannot be valued by both parties to the transaction with the same degree of facility and transparency as cash market instruments, then the OTC contact should be treated as fraudulent and banned as a matter of law and regulation. Most CDS contracts and complex structured financial instruments fall into this category of deliberately fraudulent instruments for which no cash basis exists.

What should offend the Congress about the CDS market is not just that it is deceptive by design, which it is; not just that it is a deliberate evasion of established norms of transparency and safety and soundness, norms proven in practice by the great bilateral cash and futures exchanges over decades; not that CDS is a retrograde development in terms of the public supervision and regulation of financial markets, something that gets too little notice; and not that CDS is a manifestation of the sickly business models inside the largest zombie money center banks, business values which consume investor value in multi-billion dollar chunks. No, what should bother the Congress and all Americans about the CDS market is that is violates the basic American 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 made 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 CDS and other complex derivatives, then how can we expect our financial institutions and markets to be safe and sound?

For our nation's Founders, equal representation under the law went hand in hand with proportional requital, meaning that a good deal was a fair deal, not merely in terms of price but in making sure that both parties extracted value from the bargain. A situation in which one person extracts value and another, through trickery, does not, traditionally has been rejected by Americans as a fraud. Whether through laws requiring disclosure of material facts to investors, anti-trust laws or the laws and regulations that once required virtually all securities transactions to be conducted across open, public markets, not within the private confines of a dealer-controlled monopoly, Americans have historically stood against efforts to reduce transparency and make markets less efficient - but that is precisely how this Committee should view proposals from the Obama Administration and the Treasury to "reform" the OTC derivatives markets.

To that point, consider the judgment of Benjamin M. Friedman, writing in *The New York Review of Books* on May 28, 2009, "The Failure of the Economy & the Economists." He describes the CDS market in a very concise way and in layman's terms. I reprint his comments with the permission of *NYRB:*

> "The most telling example, and the most important in accounting for today's financial crisis, is the market for credit default swaps. A CDS is, in effect, a bet on whether a specific company will default on its debt. This may sound like a form of insurance that also helps spread actual losses of wealth. If a business goes bankrupt, the loss of what used to be its value as a going concern is borne not just by its stockholders but by its creditors too. If some of those creditors have bought a CDS to protect themselves, the covered portion of their loss is borne by whoever issued the swap.
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> "But what makes credit default swaps like betting on the temperature is that, in the case of many if not most of these contracts, the volume of swaps outstanding far exceeds the amount of debt the specified company owes. Most of these swaps therefore have nothing to do with allocating genuine losses of wealth. Instead, they are creating additional losses for whoever bet incorrectly, exactly matched by gains for the corresponding winners. And, ironically, if those firms that bet incorrectly fail to pay what they owe-as would have happened if the government had not bailed out the insurance company AIG-the consequences might impose billions of dollars' worth of economic costs that would not have occurred otherwise.
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> "This fundamental distinction, between sharing in losses to the economy and simply being on the losing side of a bet, should surely matter for today's immediate question of which insolvent institutions to rescue and which to let fail. The same distinction also has implications for how to reform the regulation of our financial markets once the current crisis is past. For example, there is a clear case

> for barring institutions that might be eligible for government bailouts-including not just banks but insurance companies like AIG-from making such bets in the future. It is hard to see why they should be able to count on taxpayers' money if they have bet the wrong way. But here as well, no one seems to be paying attention."

4) CDS & Systemic Risk

While an argument can be made that currency, interest rate and energy swaps are functionally interchangeable with existing forward instruments, the credit derivative market raises a troubling question about whether the activity creates value or helps manage risk on a systemic basis. It is my view and that of many other observers that the CDS market is a type of tax or lottery that actually creates net risk and is thus a drain on the resources of the economic system. Simply stated, CDS and CDO markets currently are parasitic. These market subtract value from the global markets and society by increasing risk and then shifting that bigger risk to the least savvy market participants.

Seen in this context, AIG was the most visible “sucker” identified by Wall Street, an easy mark that was systematically targeted and drained of capital by JPM, GS and other CDS dealers, in a striking example of predatory behavior. Treasury Secretary Geithner, acting in his previous role of President of the FRBNY, concealed the rape of AIG by the major OTC dealers with a bailout totaling into the hundreds of billions in public funds.

Indeed, it is my view that every day the OTC CDS market is allowed to continue in its current form, systemic risk increases because the activity, on net, consumes value from the overall market - like any zero sum, gaming activity. And for every large, overt failure in the CDS markets such as AIG, there are dozens of lesser losses from OTC derivatives buried by the professional managers of funds and financial institutions in the same way that gamblers hide their bad bets. The only beneficiaries of the current OTC market for derivatives are JPM, GS and the other large OTC dealers.

5) <u>CDS & Securities Fraud</u>

One of the additional concerns that the Congress must address and which strongly argue in favor of outlawing the use of OTC CDS contracts entirely, is the question of fairness to investors, specifically the use of these instruments for changing the appearance but not the financial substance, of other banks and companies. The AIG collapse illustrates how CDS and similar insurance products may be used to misrepresent the financial statements of public companies and financial institutions.

In the case of AIG, the insurer was effectively renting its credit rating to other firms, and even its own affiliates, in return for making these counterparties look more sound financially than their true financial situation justified.

The use of CDS and finite insurance to window dress the financial statements of public companies is an urgent issue that deserves considerable time from the Congress to build an adequate understanding of this practice and create a public record sufficient to support legislation to ban this practice forever. For further background on the use of CDS and insurance products at AIG to commit securities fraud, see <u>"AIG: Before Credit Default Swaps, There Was Reinsurance,"</u> *The Institutional Risk Analyst*, April 2, 2009 (Copy attached). [5]

[5] See also *HARRIS v. AMERICAN INTERNATIONAL GROUP, et al.*, Los Angeles Superior Court, Central District (Case #BC414205)

Q & A

Below are my responses to the Committee's written questions.

1) How can the Congress best modernize oversight of the over-the-counter derivatives markets to increase transparency and reduce risks?

The Congress should think of modernizing the oversight of OTC derivatives in terms of restoring the existing norms of disclosure, transparency, prudential risk controls and fairness that prevail in organized, regulated markets in the US, markets such as the NYSE or CME. The existing structure of OTC derivatives is not "innovative" but rather is retrograde for the reasons suggested in the general points above regarding bank business models and the nature of the credit derivatives markets. Consider the fact, for example, that even today, market participants, regulators and the public still have no access to close-of-day prices for CDS and complex structured assets because the large dealers such as JPM and GS refuse to make this information available to the public.

In order to address this situation, Congress should take immediate action to immediately start to limit the risks posed by the operation of OTC markets. Specifically:

- Congress should subject all OTC contracts to The Commodity Exchange Act (CEA) and instruct the CFTC to begin the systematic review and rule making process to either conform OTC markets to minimum standards of disclosure, collateral and transparency, or require that the contracts be migrated onto organized, bilateral exchanges. It is time for the Congress to right the wrong done over a decade ago to Commissioner Brooksley Born and her colleagues at the CFTC. This wrong was committed in part by the Congress and in part by then-Treasury Secretary Larry Summers, then-Fed Chairman Alan Greenspan, and former Treasury Secretary Robert Rubin, among others, who all worked together to effectively block action that would have subjected OTC contracts to the full supervision of the CFTC.[6]

- The Congress should admit that it made a mistake in 2000 by blocking CFTC regulation of OTC derivatives. The Congress should take the time to document how and why Greenspan, Rubin and Summers, and others, viciously attacked the reputation and integrity of Chairman Born and other members of the CFTC, and thereby blocked CFTC regulation of OTC derivatives. The actions of Summers, Greenspan and Rubin over a decade ago to block CFTC regulation of OTC derivatives arguably created the circumstances for the collapse of AIG as well as hundreds and hundreds of billions of dollars in losses incurred by financial institutions around the world. The Congress and the people of the United States deserve to hear the explanation of Summers, Greenspan and Rubin for the actions they took and did not take in their capacity as public officials subject to congressional oversight. [7]

- I agree with the statement by Secretary Geithner last week that how and whether to combine the operations of the CFTC and the SEC is a question that needs more time and consideration than the Obama Administration has allocated for the consideration of reform for the OTC markets in 2009. I urge the Congress to move first on subjecting the OTC markets to CEA, then to take further time for hearings and fact finding to consider what other changes should occur in terms of the law and the operational structure of the SEC and CFTC.

2) As the Congress weighs proposals to move more over-the-counter derivatives transactions to central counterparties or exchanges, what key decisions need to be considered?

[6] See "Brooksley Born `Vindicated' as Swap Rules Take Shape (Update1)," *Bloomberg News*, November 13, 2009.

[7] See Dash, Eric and Schwartz, Nelson, "Where Was the Wise Man?," *The New York Times*, April 27, 2008. See also "The Subprime Three -- Rubin, Summers & Greenspan," *The Institutional Risk Analyst*, April 28, 2008.

- It is important for the Committee to understand that the reform proposal from the Obama Administration regarding OTC derivatives is a canard; an attempt by the White House and the Treasury Department to leave in place the de facto monopoly over the OTC markets by the largest dealer banks led by JPM, GS and other institutions. For example, the centralized clearing model proposed by the Treasury has some notable attributes, but still leaves the OTC markets under the complete control of the dealer banks, with little public disclosure of prices, no transparency and no accountability to other dealers and market participants. The proposal, for example, to require centralized clearing still does not address the issues of pricing, basis risk and transparency that I have raised in my comments.

- Why then are the large banks, led by JPM, engaged in such a desperate battle over the reform of the OTC derivatives markets? For the world's largest banks, the OTC derivatives markets are the last remaining source of supra-normal profits -- and also perhaps the single largest source of systemic risk in the global financial markets. Without OTC derivatives, Bear Stearns, Lehman Brothers and AIG would never have failed, but without the excessive rents earned by JPM, GS and the remaining legacy OTC dealers, the largest banks cannot survive and must shrink dramatically.

- No matter how good an operator of commercial banks JPM CEO Jamie Dimon may be, his bank is doomed without its near-monopoly in OTC derivatives -- yet that same OTC business must eventually destroy JPM and the other large dealers. Seen from that perspective, the rescues of Bear Stearns and AIG were meant to protect not investors nor the global markets, but rather to protect JPM, GS and the small group of dealers who benefit from the continuance of their monopoly over the OTC derivatives market.

- As noted above, since many OTC contracts for currencies, interest rates or energy, for example, have observable cash markets upon which to base their pricing, moving these contracts to an exchange-traded format is a relatively easy matter that does not pose significant hurdles for the Congress, investors or regulators. Indeed, most market participants would welcome and benefit from such change.

- When it comes to CDS and complex structured assets, however, it is probably not possible to move these contracts to an exchange or to continue to tolerate them as OTC instruments. Because CDS contracts generally do not have a cash market or basis upon which to draw for the purpose of valuation, as a matter of law and regulation, these instruments are entirely speculative, unsuitable for most banks and investors, and thus should be banned entirely. It is not simply a question, as some observers have suggested, of buyers of CDS having an insurable interest in the underlying basis that is the problem. Rather, because there often times is not observable cash market for say a corporate bond or a CDO, the very act of a dealer offering these instruments to a customer must be viewed as entirely speculative and thus an act of deliberate securities fraud.

- Pretending to price CDS contracts or complex structured securities using "models" is a ridiculous deception that should be rejected by the Congress and by regulators. And members of Congress should remember that federal regulators and the academic economists who populate agencies like the Fed are almost entirely captured by the largest dealer banks. Even today, the Fed and other regulatory agencies raise little or no questions as to the efficacy of OTC derivatives and the absurd quantitative models that Wall Street pretends to use to value these gaming instruments. Why? Because the Fed knows that as the Congress properly regulates OTC derivatives, the largest banks will be forced to shrink their operations, the need for a "systemic risk regulator" will fade and the role of the Fed within the financial regulatory framework will gradually diminish.

3) How would various proposals to enhance oversight of OTC derivatives affect different market participants?

Imposing appropriate prudential and legal limitations on OTC derivatives would have enormous benefits for investors in terms of better pricing, increase transparency regarding market and liquidity risk, and improved surveillance and oversight by regulators. The notion that requiring basic norms of price discovery and disclosure for

OTC markets will hurt "innovation" is an absurd position and only illustrates the grotesque conflict of interest that now infects the dealers and federal regulators.

If one equates "innovation" with fraud and criminality, then yes regulation of OTC derivatives will certainly hurt innovation. But if the Congress does its duty and acts to conform the unregulated, opaque OTC markets to the basic standards of honesty and openness that have been the minimum requirement for markets in this country for over a century, then there should be no concern about stifling "innovation."

Let's make a list of participants and suggest some winners and losers from OTC reform:

<u>Investors in Financial Markets</u>: Big winners. Better pricing, more transparency, less "innovation" and thus reduced market and liquidity risk, fewer opportunities for severe loss and/or public bailouts.

<u>Taxpayers</u>: Big winners. Less systemic risk, less cost for bailouts of financial institutions, and <u>less time spent by the Congress considering problems that should not exist in the first instance</u>.

<u>Consumers</u>: Big winners. By limiting the complexity of financial instruments, the Congress can act to limit predatory behavior by lenders and major Wall Street dealer firms. If you do not allow overly-complex financial instruments to exist in the first place, then the Congress will effectively limit systemic risk in financial markets.

<u>Dealers</u>: Winners. Less risk, lower returns, makes dealers more stable and less likely to require a public bailout. The illusory, short-term returns for dealers will fall, and with it the supra-normal compensation for traders and executives of the dealers, but the long-term risk-adjusted returns for large dealers will rise and the shareholders of the dealers will benefit.

4) How does the issue of improved OTC derivatives regulation relate to broader regulatory reform issues such as the creation of a new systemic risk regulator, and to what extent do our efforts require international coordination?

“Systemic risk” is a political concept that does not belong in law or regulation. The perception of “systemic risk,” which is another way of describing the human emotion of fear, is a function of inefficient markets and opaque, illiquid financial instruments such as CDS and complex structured assets. If the Congress acts to impose regulation on the OTC derivatives markets, then the perceived need for a systemic risk regulator will disappear. The phenomenon of “systemic risk” is a function of the fear among investors at least partly caused by the supra-normal returns earned by participants in the OTC markets. Once these markets are brought back within the established norms of fairness and transparency, and the nominal rates of return fall to the same levels as those earned in established public markets, then the problem of “systemic risk” will fade.

The key thing for the public and the Congress to understand is that the "profits" earned from unregulated derivatives markets are illusory and do not cover the true “systemic” risk posed by the continued tolerance of OTC derivative markets. Put another way, on a systemic basis, risk-adjusted profits from OTC derivatives are not positive over time because OTC markets create risk and opportunities for loss that would not otherwise exist. The net loss from the periodic collapse of what is best described as gaming activity gets off-loaded onto the taxpayer, thus OTC derivatives must be seen as any other speculative activity, namely a net loss to the economy and society.

If the Congress has the courage and the vision to act now to regulate and migrate to an exchange model those OTC markets that have a real, observable basis and ban those OTC instruments that do not have such a foundation, then the need for a systemic risk regulator will disappear and the only need for international coordination will be for the governments of the industrial nations to celebrate the end of one of the darkest, most alarming periods of speculative mania seen in many generations. Thank you.

AIG: Before Credit Default Swaps, There Was Reinsurance

The Institutional Risk Analyst
April 2, 2009

"What do many corporate buyers of insurance have in common with American International Group? Perhaps more than they would like to admit. Like AIG, many companies in the past few years have bought finite insurance, which transfers a prescribed amount of risk for a particular liability. What regulators now want to know is, how many companies, like AIG, have used finite insurance to artificially inflate their financial results?"

Infinite Risk?
CFO Magazine
June 1, 2005

"In the regulatory world, a 'side letter' is perhaps the most insidious and destructive weapon in the white-collar criminal's arsenal. With the flick of a pen, underhanded executives can cook the books in enormous amounts and render a regulator helpless."

Fraud Magazine
July/August 2006

For some time now, we have been trying to reconcile the apparent paradox of American International Group (NYSE:AIG) walking away from the highly profitable, double-digit RAROC business of underwriting property and casualty (P&C) risk and diving into the rancid cesspool of credit default swaps ("CDS") contracts and other types of "high beta" risks, business lines that are highly correlated with the financial markets.

In our interview with Robert Arvanitis last year, "'Bailout: It's About Capital, Not Liquidity; Seeking Beta: Interview with Robert Arvanitis', September 29, 2008," we discussed the difference between high and low beta. We also learned from Arvanitis, who worked for AIG during much of the relevant period, that the decision by Hank Greenberg and the AIG board to enter the CDS market was, at best, chasing revenue. No rational examination of the business opportunity, assuming that Greenberg and his directors were acting based on a reasoned analysis, could have resulted in a favorable decision to pursue CDS and other "high beta" risks, at least from our perspective.

In an effort to resolve this conundrum, over the past several months The IRA has interviewed a number of forensic experts, insurance regulators and members of the law enforcement community focused on financial fraud. The picture we have assembled is frightening and suggests that, far from just AIG, much of the insurance industry has been drawn into the world of financial engineering and has thus become part of the problem. Below we present our preliminary findings and invite your comments.

One of the first things we learned about the insurance world is that the concept of "shifting risk" for a variety of business and regulatory reasons has been ongoing in the insurance world for decades. Finite insurance and other scams have been at least visible to the investment community for years and have been documented in the media, but what is less understood is that firms like AIG took the risk shifting shell game to a whole new level long before the firm's entry into the CDS market.

In fact, our investigation suggests that by the time AIG had entered the CDS fray in a serious way more than five years ago, the firm was already doomed. No longer able to prop up its earnings using reinsurance because of growing scrutiny from state insurance regulators and federal law enforcement agencies, AIG's foray into CDS was really the grand finale. AIG was a Ponzi scheme plain and simple, yet the Obama Administration still thinks of AIG as a real company that simply took excessive risks. No, to us what the fraud Bernard Madoff is to individual investors, AIG is to the global financial community.

As with the phony reinsurance contracts that AIG and other insurers wrote for decades, when AIG wrote hundreds of billions of dollars in CDS contracts, neither AIG nor the counterparties believed that the CDS would ever be paid. Indeed, one source with personal knowledge of the matter suggests that there may be emails and actual side letters between AIG and its counterparties that could prove conclusively that AIG never intended to pay out on any of its CDS contracts.

The significance of this for the US bailout of AIG is profound. If our surmise is correct, the position of Feb Chairman Ben Bernanke and Treasury Secretary Tim Geithner that the AIG credit default contracts are "valid legal contracts" is ridiculous and reveals a level of ignorance by the Fed and Treasury about the true goings on inside AIG and the reinsurance industry that is truly staggering.

Does Reinsurance + Side Letters = CDS?

One of the most widespread means of risk shifting is reinsurance, the act of paying an insurer to offset the risk on the books of a second insurer. This may sound pretty routine and plain vanilla, but what most people don't know is that often times when insurers would write reinsurance contracts with one another, they would enter into "side letters" whereby the parties would agree that the reinsurance contract was essentially a canard, a form of window dressing to make a company, bank or another insurer look better on paper, but where the seller of protection had no intention of ever paying out on the contract.

Let's say that an insurer needs to enhance its capital surplus by $100 million in order to meet regulatory capital requirements. They can enter into what appears to be a completely legitimate form of reinsurance contract, an agreement that appears to transfer the liability to the reinsurer. By doing so, the "ceding company" - an insurance company that transfers a risk to a reinsurance company - gets to drop that $100 million in liability and its regulatory surplus increases by $100 million.

The reinsurer assuming the risk does actually put up the $100 million in liability, but with the knowledge that they will never have to actually pay out on the contract. This is good for the reinsurer because they are paid a fee for this transaction, but it is bad for the ceding company, the insurer with the capital shortfall, because the transaction is actually a sham, a fraud meant to deceive regulators, counterparties and investors into thinking that the insurer has adequate capital. Typically the fee is 6% per year or what is called a "loan fee" in the insurance industry.

When it operates in this fashion, the whole reinsurance industry could be described as a "surplus rental" proposition, whereby an insurer literally loans another insurer capital in the form of risk cover, but with a secret understanding in the form of a side letter that the loan will be reversed without any recourse to the seller of protection. You give me $6 million in cash today, and I will give you a promise that we both know I will never honor.

Does this sound familiar? What our contacts in the insurance industry describe is almost a precise description of the CDS market, albeit one that evolved in the reinsurance industry literally decades ago and has been the cause of numerous insurance insolvencies and losses to insured parties. Or to put it another way, maybe the inspiration for the CDS market - at least within AIG and other insurers -- evolved from the reinsurance market over the past two decades.

As best as we can tell, the questionable practice of using side letters to mask the economic and business reality of reinsurance transactions started in the mid-1980s and continued until the middle of the current decade. This timeline just happens to track the creation and evolution of the OTC derivatives markets. In particular, the move by AIG into the CDS market coincides with the increased awareness of and attention to the use of side letters by insurance regulators and members of the state and federal law enforcement community.

Keep in mind that what we are talking about here are not questionable risk management policies but acts of deliberate and criminal fraud, acts that often result in jail time for those involved. As one senior forensic accountant who has practiced in the insurance sector for three decades told The IRA:

"In every major criminal fraud case in which I have worked, at the center of the investigation were these side letters. It was always very strange to me that on-site investigators and law enforcement officials consistently found that these side letters were being used to mask the true financial condition of an insurer, and yet none of the state regulators, the National Association of Insurance Commissioners (NAIC), nor federal law enforcement authorities ever publicly mentioned the practice. They certainly did not act like the use of side letters was a commonplace thing, but it was widespread in the industry."

It is important to understand that a side letter is a secret agreement, a document that is often hidden from internal and external auditors, regulators and even senior management of insurers and reinsurers. We doubt, for example, that Warren Buffet or Hank Greenberg knew the details of side letters, but they should have. Just as a rogue CDS trader at a large bank like Societe General (NYSE:SGE) might seek to hide losing trades, the underwriters of insurers would use sham transactions and side letters to enhance the revenue of the insurer, but without disclosing the true nature of the transaction.

There are two basic problems with side letters. First, they are a criminal act, a fraud that usually carries the full weight of an "A" felony in many jurisdictions. Second, once the side letter is discovered by a persistent auditor or regulator examining the buyer of protection, the transaction becomes worthless. You paid $6 million to AIG to shift risk via the reinsurance, but the side letter makes clear that the transaction is a fraud and you lose any benefit that the apparent risk shifting might have provided.

As the use of these secret side letters began to become more and more prevalent in the insurance industry, and these secret side deals were literally being stacked on top of one another at firms like AIG, the SEC began to investigate. And they began to find instances of fraud and to crack down on the practice. One of the first cases to come to the surface involved AIG helping Brightpoint (NASDAQ:CELL) commit accounting fraud, a case that eventually led the SEC to fine AIG $10 million in 2003.

Wayne M. Carlin, Regional Director of the SEC's Northeast Regional Office, said of the settlements: "In this case, AIG worked hand in hand with CELL personnel to custom-design a purported insurance policy that allowed CELL to overstate its earnings by a staggering 61 percent. This transaction was simply a 'round-trip' of cash from CELL to AIG and back to CELL. By disguising the money as 'insurance,' AIG enabled CELL to spread over several years a loss that should have been recognized immediately."

Another case involved PNC Financial (NYSE:PNC), which used various contracts with AIG to hide certain assets from regulators, even though the transaction amounted to the "rental" of capital and not a true risk transfer.

As the SEC noted in a 2004 statement: "The Commission's action arises out of the conduct of Defendant AIG, primarily through its wholly owned subsidiary AIG Financial Products Corp. ("AIG-FP"), (collectively referred to as "AIG") in developing, marketing, and entering into transactions that purported to enable a public company to remove certain assets from its balance sheet." Click here to see the SEC statement regarding the AIG transactions with PNC.

The SEC statement reads in part: "In its Complaint, filed in the United States District Court for the District of Columbia, the Commission alleged that from at least March 2001 through January 2002, Defendant AIG, primarily through AIG-FP, developed a product called a Contributed Guaranteed Alternative Investment Trust Security ("C-GAITS"), marketed that product to several public companies, and ultimately entered into three C-GAITS transactions with one such company, The PNC Financial Services Group, Inc. ("PNC"). For a fee, AIG offered to establish a special purpose entity ("SPE") to which the counter-party would transfer troubled or other potentially volatile assets. AIG represented that, under generally accepted accounting principles ("GAAP"), the SPE would not be consolidated on the counter-party's financial statements. The counter-party thus would be able to avoid charges to its income statement resulting from declines in the value of the assets transferred to the SPE. The transaction that AIG developed and marketed, however, did not satisfy the requirements of GAAP for nonconsolidation of SPEs."

In both cases, AIG was engaged in transactions that were meant not to reduce risk, but to hide the true nature of the risk in these companies from investors, regulators and the consumers who rely on these institutions for services. Keep in mind that while the SEC did act to address these issues, the parties involved received light punishments when you consider that these are all felonies that arguably would call for criminal prosecution for fraud, securities fraud, conspiracy and racketeering, among other things. Indeed, this is one of those rare cases where we believe AIG itself, as a corporate person, should be subject to criminal prosecution and liquidation.

Birds of a Feather: AIG & GenRe

Click here to see a June 6, 2005 press release from the SEC detailing criminal charges against John Houldsworth, a former senior executive of General Re Corporation ("GenRe"), a subsidiary of Berkshire Hathaway (NYSE:BRKA), for his role in aiding and abetting American International Group, Inc. in committing securities fraud.

The SEC noted: "In its complaint filed today in federal court in Manhattan, the Commission alleged that Houldsworth and others helped AIG structure two sham reinsurance transactions that had as their only purpose to allow AIG to add a total of $500 million in phony loss reserves to its balance sheet in the fourth quarter of 2000 and the first quarter of 2001. The transactions were initiated by AIG to quell criticism by analysts concerning a reduction in the company's loss reserves in the third quarter of 2000."

But the involvement of the BRKA unit GenRe in the AIG mess was not the first time that GenRe had been involved in the questionable use of reinsurance contracts and side letters.

Click here to see an example of a side letter that was made public in a civil litigation in Australia a decade ago. The faxed letter, which bears the ID number from the Australian Court, is from an insurance broker in London to Mr. Ajit Jain, a businessman who currently heads several reinsurance businesses for BRKA, regarding a reinsurance contract for FAI Insurance, an affiliate of HIH Insurance.

Notice that the letter states plainly the intent of the transaction is to bolster the apparent capital of FAI. Notice too that several times in the letter, the statement is made that "no claim will be made before the commutation date," which may be interpreted as being a warranty by the insured that no claims shall be made under the reinsurance policy. By no coincidence, HIH and FAI collapsed in a $5.3 billion dollar fiasco that ranks as Australia's biggest ever corporate failure.

Click here to read a March 9, 2009 article from The Age, one of Australia's leading business publications, regarding the collapse of HIH and FAI.

In 2003, an insurer named Reciprocal of America ("ROA") was seized by regulators and law enforcement officials. An investigation ensued for 3 years. According to civil lawsuits filed in the matter, GenRe provided finite insurance to ROA in order to make the troubled insurer look more solvent than it was in reality. Several regulators and law enforcement officials involved in that case tell The IRA that the ROA failure forced insurers like AIG and Gen Re to start looking for new ways to "cook the books" because the long-time practice of side letters was starting to come under real scrutiny.

"These reinsurance deals made ROA look better than it really was," one investigator with direct knowledge of the ROA matter tells The IRA. "They went into the ROA home office in VA with the state insurance regulators and law enforcement, and directed the employees away from the computers and records. During that three-year investigation, GenRe learned that local regulators and forensic examiners had put everything together and that we now understood the way the game was played. I believe the players in the industry realized that that they had to change the way in which they cooked the books. A sleight- of-hand trick that had worked for 25 years under the radar of regulators and investors was now revealed."

Several senior officials of ROA eventually were prosecuted, convicted of criminal fraud and imprisoned, but DOJ officials under the Bush Administration reportedly blocked prosecution of the actual managers and underwriters of ROA who were involved in these sham transactions, this even though state officials and federal prosecutors in VA were anxious to proceed with additional prosecutions.

AIG: From Reinsurance to CDS

While some reinsurers are large, well-capitalized entities that generally avoid these pitfalls, AIG was already a troubled company when it began to write more and more of these risk-shifting transactions more than a decade ago. It is easy to promise the moon when people think that they can deliver, but because AIG and their clients saw how easy it was to fool regulators and investors, the practice grew and most regulators did absolutely nothing to curtail the practice.

It was easy for AIG to become addicted to the use of side letters. The firm, which had already encountered serious financial problems in 2000-2001, reportedly saw the side letters as a way to mint free money and thereby help the insurer to look stronger than it really was. AIG not only helped banks and other companies distort and obfuscate their financial condition, but AIG was supplementing its income by writing more and more of these reinsurance deals and mitigating their perceived exposure via side letters.

A key figure in AIG's reinsurance schemes, according to several observers, was Joseph Cassano, head of AIG-FP. Whereas the traditional use of side letters was in reinsurance transactions between insurers, in the case of both CELL and PNC neither was an insurer!

And in both cases, AIG used sham deals to make two non-insurers, including a regulated bank holding company, look better by manipulating their financial statements. Falsifying the financial statements of a bank or bank holding company is an felony.

AIG-FP was simply doing for non-insurers what was common practice inside the secretive precincts of the insurance world. The SEC did investigate and they did finally obtain a deferred prosecution agreement with AIG, which was buried in the settlement with then-New York AG Elliott Spitzer.

The key thing to understand is that if you look at many of these reinsurance contracts between ROA and Gen Re, they look perfect. They appear to transfer risk and seem to be completely in order. But, if you don't get to see the secret agreement, the side letter that basically says that the reinsurance contract is a form of window dressing, then you cannot understand the full implications of the transaction, the reinsurance agreement. Not, several experts speculate, can you understand why AIG decided to migrate away from reinsurance and side letters and into CDS as a mechanism for falsifying the balance sheets and earnings of non-insurers.

Several observers believe that at some point in the 2002-2004 period, Cassano and his colleagues at AIG began to realize that state insurance regulators and the FBI where on to the reinsurance/side letter scam. A number of experts had been speaking and writing about the issue within the accounting and fraud communities, and this attention apparently made AIG move most of its shell game into the world of CDS. By no coincidence, at around this time side letters began to disappear in the insurance industry, suggesting to many observers that the industry finally realized that the jig was up.

It appears to us that, seeing the heightened attention from regulators and federal law enforcement agencies such as the FBI on side letters, AIG began to move its shell game to the CDS markets, where it could continue to falsify the balance sheets and income statements of non-insurers all over the world, including banks and other financial institutions.

AIG's Cassano even managed to hide the activity in a bank subsidiary of AIG based in London and under the nominal supervision of the Office of Thrift Supervision in the US, this it is suggested to hide this ongoing activity from US insurance regulators. Even though AIG had been investigated and sanctioned by the SEC, Cassano and his colleagues at AIG apparently were recalcitrant and continued to build the CDS pyramid inside AIG, a financial pyramid that is now collapsing. The rest, as they say is history.

Now you know why the Fed and EU officials are so terrified about an AIG liquidation, because it will result in heavy losses to or even the insolvency of banks and other corporations around the globe. Notice that while German Chancellor Angela Merkel has been posturing and throwing barbs at President Obama, French President Nicolas Sarkozy has been conciliatory toward the US.

But for the bailout of AIG, you see, President Sarkozy would have been forced to bailout SGE for a second time in two years. So long as the Fed and Treasury can subsidize AIG's mounting operating losses, the EU will be spared a financial bloodbath. But this situation is unlikely to remain stable for long with members of the Congress demanding an investigation of the past bailout, a process that can only result in bankruptcy for AIG.

Are the CDS Contracts of AIG Really Valid?

The key point is that neither the public, the Fed nor the Treasury seem to understand is that the CDS contracts written by AIG with these various non-insurers around the world were shams - with no correlation between "fees" paid and the risk assumed. These were not valid contracts as Fed Chairman Ben Bernanke, Treasury Secretary Geithner and Economic policy guru Larry Summers claim, but rather acts of criminal fraud meant to manipulate the capital positions and earnings of financial companies around the world.

Indeed, our sources as well as press reports suggest that the CDS contracts written by AIG may have included side letters, often in the form of emails rather than formal letters, that essentially violated the ISDA agreements and show that the true, economic reality of these contracts was fraud plain and simple. Unfortunately, by not moving to seize AIG immediately last year when the scandal broke, the Fed and Treasury may have given the AIG managers time to destroy much of the evidence of criminal wrongdoing.

Only when we understand how AIG came to be involved in CDS and the fact that this seemingly illegal activity was simply an extension of the reinsurance/side letter shell game scam that AIG, Gen Re and others conducted for many years before will we understand what needs to be done with AIG, namely liquidation. Seen in this context, the payments made to AIG by the Fed and Treasury, which were then passed-through to dealers such as Goldman Sachs (NYSE:GS), can only be viewed as an illegal taking that must be reversed once the US Trustee for the Federal Bankruptcy Court for the Southern District of New York is in control of AIG's operations.

Editor's note: Officials of BRKA and GenRe did not respond to telephonic and email requests by The IRA seeking comment on this article. An official of AIG did respond but was not willing to comment on-the-record for this report. We shall be happy to publish any written comments that BRKA, AIG or GenRe have on this article.

Click here to see comments on this article posted on TheBigPicture.

Questions? Comments? info@institutionalriskanalytics.com

Other Readings

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