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Gambling with the economy

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While the Securities and Exchange Commission's allegations that Goldman Sachs defrauded clients is certainly big news, the case also raises a far broader issue that goes to the heart of how Wall Street has strayed from its intended mission.

Wall Street's purpose, you will recall, is to raise money for industry: to finance steel mills and technology companies and, yes, even mortgages. But the collateralized debt obligations involved in the Goldman trades, like billions of dollars of similar trades sponsored by most every Wall Street firm, raised nothing for nobody.

In essence, they were simply a side bet — like those in a casino — that allowed speculators to increase society's mortgage wager without financing a single house.

The mortgage investment that is the focus of the S.E.C.'s civil lawsuit against Goldman, Abacus 2007-AC1, didn't contain any actual mortgage bonds. Rather, it was made up of credit default swaps that "referenced" such bonds. Thus the investors weren't truly "investing" — they were gambling on the success or failure of the bonds that actually did own mortgages. Some parties bet that the mortgage bonds would pay off; others (notably the hedge fund manager John Paulson) bet that they would fail. But no actual bonds — and no actual mortgages — were created or owned by the parties involved.

The S.E.C. suit charges that the bonds referenced in Goldman's Abacus deal were hand-picked (by Mr. Paulson) to fail. Goldman says that Abacus merely allowed Mr. Paulson to bet one way and investors to bet the other. But either way, is this the proper function of Wall Street? Is this the sort of activity we want within regulated (and implicitly Federal Reserve-protected) banks like Goldman?

While such investments added nothing of value to the mortgage industry, they weren't harmless. They were one reason the housing bust turned out to be more destructive than anyone predicted. Initially, remember, the Federal Reserve chairman, Ben Bernanke, and others insisted that the damage would be confined largely to subprime loans, which made up only a small part of the mortgage market. But credit default swaps greatly multiplied the subprime bet. In some cases, a single mortgage bond was referenced in dozens of synthetic securities. The net effect: Investments like Abacus raised society's risk for no productive gain.

In a free-market economy, we want people making considered calculations of risk. But buyers and sellers of credit default swaps often have no stake in the underlying instrument. Such swaps function like an insurance policy. One party collects a fee for promising to, in effect, insure a bond; the other party makes the premium payments, and gets a big payoff if the bond goes bad.

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Banks that have lent money to questionable borrowers use swaps as a hedge — if their loans go bad, the bank makes up for the loss by collecting on the swap. The problem is that swaps are open to anyone — even parties with nothing to insure. Allowing speculators to bet on entities in which they have no stake is similar to letting your neighbor take out an insurance policy on your life.

And even when these instruments are used by banks to hedge against potential defaults, they raise a moral hazard. Banks are less likely to scrutinize mortgages and other loans they make if they know they can reduce risk using swaps. The very ease with which derivatives allow each party to "transfer" risk means that no one party worries as much about its own risk. But, irrespective of who is holding the hot potato when the music stops, the net result is a society with more risk overall.

As it considers its financial reform options, the U.S. Congress's first priority should be to end the culture that "financializes" every economic outcome, that turns every mortgage or bond issue into a lottery — often with second- and third-order securities that amount to wagers on wagers of numbing complexity.

First, it should insist that all derivatives trade on exchanges and in standard contracts — not in customized, build-to-suit arrangements like the ones Goldman created. Wall Street might have legal grounds to fight this — after all, a derivative is a contract between private parties. But the financial bailout has demonstrated that big Wall Street banks fall firmly within Washington's regulatory authority, and regulation confers implicit bailout protection. Protected entities should not be using (potentially) public capital to run non-productive gambling tables.

Second, Congress should take up the question of whether parties with no stake in the underlying instrument should be allowed to buy or sell credit default swaps. If it doesn't ban the practice, it should at least mandate that regulators set stiff capital requirements on swaps for such parties so that they will not overleverage themselves again to society's detriment. Also, tax policy could be changed to skew heavily against swaps contracts that are held for short-term periods.

The government would not look fondly on Caesar's Palace if it opened a table for wagering on corporate failure. It should not give greater encouragement for Goldman Sachs to do so.

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