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The Bet That Blew Up Wall Street

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(CBS) The world's financial system teetered on the edge again last week, and anyone with more than a passing interest in their shrinking 401(k) knows it's because of a global credit crisis. It began with the collapse of the U.S. housing market and has been magnified worldwide by what Warren Buffet once called "financial weapons of mass destruction."

They are called credit derivatives or credit default swaps, and ***60 Minutes*** did a story on the multi-trillion dollar market three weeks ago. But there's a lot more to tell.

As **Steve Kroft** reports, essentially they are side bets on the performance of the U.S. mortgage markets and the solvency on some of the biggest financial institutions in the world. It's a form of legalized gambling that allows you to wager on financial outcomes without ever having to actually buy the stocks and bonds and mortgages.

It would have been illegal during most of the 20th century, but eight years ago Congress gave Wall Street an exemption and it has turned out to be a very bad idea.

While Congress and the rest of the country scratched their heads trying to figure out how we got into this mess, ***60 Minutes*** decided to go to Frank Partnoy, a law professor at the University of San Diego, who has written a couple of books on the subject.

Ask to explain what a derivative is, Partnoy says, "A derivative is a financial instrument whose value is based on something else. It's basically a side bet."

Think of it for a moment as a football game. Every week, the New York Giants take the field with hopes of getting back to the Super Bowl. If they do, they will get more money and glory for the team and its owners. They have a direct investment in the game. But the people in the stands may also have a financial stake in the ouctome, in the form of a bet with a friend or a bookie.

"We could call that a derivative. It's a side bet. We don't own the teams. But we have a bet based on the outcome. And a lot of derivatives are bets based on the outcome of games of a sort. Not football games, but games in the markets," Partnoy explains.

Partnoy says the bet was whether interest rates were going to go up or down. "And the new bet that arose over the last several years is a bet based on whether people will default on their mortgages."

And that was the bet that blew up Wall Street. The TNT was the collapse of the housing market and the failure of complicated mortgage securities that the big investment houses created and sold around the world.

But the rocket fuel was the trillions of dollars in side bets on those mortgage securities, called "credit default swaps." They were essentially private insurance contracts that paid off if the investment went bad, but you didn't have to actually own the investment to collect on the insurance.

"If I thought certain mortgage securities were gonna fail, I could go out and buy insurance on them without actually owning them?" Kroft asks Eric Dinallo, the insurance superintendent for the state of New York.

"Yeah," Dinallo says. "The irony is, though, you're not really buying insurance at that point. You're just placing the bet."

Dinallo says credit default swaps were totally unregulated and that the big banks and investment houses that sold them didn't have to set aside any money to cover their potential losses and pay off their bets.

"As the market began to seize up and as the market for the underlying obligations began to perform poorly, everybody wanted to get paid, had a right to get paid on those credit default swaps. And there was no 'there' there. There was no money behind the commitments. And people came up short. And so that's to a large extent what happened to Bear Sterns, Lehman Brothers, and the holding company of AIG," he explains.

In other words, three of the nation's largest financial institutions had made more bad bets than they could afford to pay off. Bear Stearns was sold to J.P. Morgan for pennies on the dollar, Lehman Brothers was allowed to go belly up, and AIG, considered too big to let fail, is on life support to thanks to a $123 billion investment by U.S. taxpayers.

"It's legalized gambling. It was illegal gambling. And we made it legal gambling…with absolutely no regulatory controls. Zero, as far as I can tell," Dinallo says.

"I mean it sounds a little like a bookie operation," Kroft comments.

"Yes, and it used to be illegal. It was very illegal 100 years ago," Dinallo says.

In the early part of the 20th century, the streets of New York and other large cities were lined with gaming establishments called "bucket shops," where people could place wagers on whether the price of stocks would go up or down without actually buying them. This unfettered speculation contributed to the panic and stock market crash of 1907, and state laws all over the country were enacted to ban them.

"Big headlines, huge type. This is the front page of the New York Times," Dinallo explains, holding up a headline that reads "No bucket shops for new law to hit."

"So they'd already closed up 'cause the law was coming. Here's a picture of one of them. And they were like parlors. See," Dinallo says. "Betting parlors. It was a felony. Well, it was a felony when a law came into effect because it had brought down the market in 1907. And they said, 'We're not gonna let this happen again.' And then 100 years later in 2000, we rolled them all back."

The vehicle for doing this was an obscure but critical piece of federal legislation called the Commodity Futures Modernization Act of 2000. And the bill was a big favorite of the financial industry it would eventually help destroy.

It not only removed derivatives and credit default swaps from the purview of federal oversight, on page 262 of the legislation, Congress pre-empted the states from enforcing existing gambling and bucket shop laws against Wall Street.

"It makes it sound like they knew it was illegal," Kroft remarks.

"I would agree," Dinallo says. "They did know it was illegal. Or at least prosecutable."

In retrospect, giving Wall Street immunity from state gambling laws and legalizing activity that had been banned for most of the 20th century should have given lawmakers pause, but on the last day and the last vote of the lame duck 106th Congress, Wall Street got what it wanted when the Senate passed the bill unanimously.

"There was an awful lot of, 'Trust us. Leave it alone. We can do it better than government,' without any realistic understanding of the dangers involved," says Harvey Goldschmid, a Columbia University law professor and a former commissioner and general counsel of the Securities and Exchange Commission.

He says the bill was passed at the height of Wall Street and Washington's love affair with deregulation, an infatuation that was endorsed by President Clinton at the White House and encouraged by Federal Reserve Chairman Alan Greenspan.

"That was the wildest and silliest period in many ways. Now, again, that's with hindsight because the argument at the time was these are grownups. They're institutions with a great deal of money. Government will only get in the way. Fears it will be taken overseas. Leave it alone. But it was a wrong-headed argument. And turned out to be, of course, extraordinarily unwise," Goldschmid says.

Asked what role Greenspan played in all of this, Professor Goldschmid says, "Well, he made clear in his public speeches and book that a Libertarian drive was part of the way he looked at the world. He's a very talented man. But that didn't take us where we had to be."

"Alan was the most powerful man in Washington in a real sense. Certainly a rival to the president and had enormous influence on Capitol Hill," Goldschmid says,

"And he was at the height of his power," Kroft adds.

Within eight years, unregulated derivatives and swaps helped produce the largest financial services economy the United States has ever had. Estimates of the market for credit default swaps grew from $100 billion to more than $50 trillion, and you could bet on anything from the solvency of communities to the fate of General Motors.

It also produced a huge transfer of private wealth to Wall Street traders and investment bankers, who collected billions of dollars in bonuses. A lot of the money was made financing what seemed to be a never-ending housing boom, selling mortgage securities they thought were safe and credit default swaps that would never have to be paid off.

"The credit default swaps was the key of what went wrong and what's created these enormous losses," Goldschmid says.

"Is it your impression that people at the big Wall Street investment houses knew what was going on and knew the kind of risks that they were exposed to?" Kroft asks.

"No. My impression is to the contrary, that even at senior levels they only vaguely understood the risks. They only vaguely followed what was going on," Goldschmid says. "And when it tumbled, there was some genuine surprise not only at the board level where there wasn't enough oversight but at senior management level."

They didn't know what was going on in part because credit default swaps were totally unregulated. No one knew how many there were or who owned them. There was no central exchange or clearing house to keep track of all the bets and to hold the money to make sure they got paid off. Eventually, savvy investors figured out that the cheapest, most effective way to bet against the entire housing market was to buy credit defaults swaps, in effect taking out inexpensive insurance policies that would pay off big when other people's mortgage investments went south.

"I know people personally who have taken away more than $1 billion from having been on the right side of these transactions," says Jim Grant, publisher of Grant's Interest Rate Observer and one of the country's foremost experts on credit markets.

"If you can and you could lay down cents on the dollar to place a bet on the solvency of Wall Street, for example, as some did, when Wall Street became evidently insolvent, that cents on the dollar bet went up 30, 40, and 50 fold. Not everyone who did that wants to get his name in the paper. But there are some spectacularly rich people who came out of this," Grant says.

"Who got richer," Kroft remarks.

"Who got richer, who became, you know, fantastically richer," Grant says.

A lot of them were hedge fund managers. John Paulson's Credit Opportunities Fund returned almost 600 percent last year, with Paulson pocketing a reported $3.7 billion.

Bill Ackman, of Pershing Square Capital Management, said he plans to make hundreds of millions. Both declined ***60 Minutes'*** request for an interview.

Congress now seems shocked and outraged by the consequences of its decision eight years ago to effectively deregulate swaps and derivatives. Various members of the House and Senate have hauled in the usual suspects to accept or share the blame.

"Were you wrong?" Rep. Henry Waxman asked former Federal Reserve Chairman Greenspan.

"Credit default swaps, I think, have some serious problems with them," Greenspan replied.

It appears to be the first step in a long process of restoring at least some of the regulations and safeguards that might have prevented, or at least mitigated this disaster after the damage has already been done.

Where do we go from here?

"We need the most dramatic rethinking of the regulatory scheme for financial markets since the New Deal. If anything has demonstrated that imperative, it's the economy right now and the tragic circumstances we're in," Goldschmid says.

Asked how much danger he thinks is still out there, Goldschmid says, "We don't know. Part of the problem of the lack of transparency in these - in these markets has been we don't really know."

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