Sometimes, Holding the Line *is* Progress

Written by Bill Harrington

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> "*Croatan Institute is an independent, nonprofit research and action institute whose mission is to build social equity and ecological resilience by leveraging finance to create pathways to a just economy.*"
> - Croatan Institute Mission Statement

There are innumerable "*pathways to a just economy*". One pathway is the preservation of a useful status quo that benefits everyone. Also, there are innumerable "*actions . . . to create"* a pathway to a just economy. One action is to block change that would destroy a useful status quo that benefits everyone. Finally, "*leveraging finance"* can mean *leveraging against finance* when practitioners push to harm everyone by undoing a useful status quo.

Since 2011, I have acted to prevent U.S. financial dealmakers such as the largest banks and investment companies from using a ruinous financial contract that caused and prolonged the 2008 financial crisis. My work comprehensively demonstrates that the contract in question is, by intentional design, intrinsically destructive. The contract undermines social compacts around the world, including efforts to "*build social equity and ecological resilience*".

Fortunately for U.S. persons, our law and regulation render the contract in question commercially impracticable in the U.S. However, the good fortune is tenuous because financial dealmakers and industry groups periodically push for statutory and regulatory "relief" to revive the contract. Luckily, my eleven-year-and-counting advocacy has just scored a major win that will at least slow, and might permanently block, contract revival in the U.S.

"The Big Short" Short-Changed the Swap-Contact-with-Flip-Clause

The contract in question, "the swap-contract-with-flip-clause", is used by dealmakers the world over to assemble complex-finance deals on the cheap. From the get-go, each artificially "cheap" deal distorts price signals and investment for all types of projects, including ones that foster sustainability and resilience. Over the long-term, "cheap" deals can implode and tax everyone in the form of bail-outs, deferred investment, and accelerated social fragmentation. Artificially cheap complex-finance deals with an artificially cheap swap-contract-with-flip-clause include asset-backed securities, such

as deals backed by residential mortgages, student loan debt, and corporate debt. Also, doubly complex deals that themselves own asset-back securities often have a swap-contract-with-flip-clause.

> "*ABS deals that embed flip clause swaps belong in the dustbin of failed products along with other synthetic concoctions such as aerosol sprays, asbestos tiles, and trans fats.*"
> - "Can Green Bonds Flourish in a Complex-Finance Brownfield?", *Croatan Institute Working Paper*, page 9

Every swap contract that "The Big Short" detailed was a swap-contract-with-flip-clause, although neither the book nor the movie identified any swap contract as such. Likewise, many, many more contracts that damaged the U.S. and the rest of the world in 2008 were swap contracts with flip clauses but not identified as such. In one notorious instance, a single swap contract that was central to the entire Greek financial crisis was a swap-contract-with-flip-clause.

Among complex-finance practitioners such as accountants, bankers, bond analysts, and legal counsel, the swap-contract-with-flip-clause is an unacknowledged open secret. No financial practitioner does defensible work on the contract because all practitioners that use the contract deliberately ignore deficiencies that stare them in the eye. The global credit rating companies Fitch Ratings, S&P Global Ratings, and my former employer Moody's Investors Service amplify the "see no evil" approach in posting credit ratings and methodologies for practitioners the world over to exploit. Extending the systemic damage, Fitch, Moody's, and S&P are swamping ESG rating and analyses with the same "see no evil" methods.

My Croatan Institute work enables me to bring the complex-finance open secret into the big, wide open and keep it there. In 2018, the Institute posted my working paper, the only work in the world that not only describes the swap-contract-with-flip-clause, but also documents use of the contract and proposes a "financial sustainability score" to measure impact on the financial system itself. To be very clear, my working paper presents resourceful, robust analyses that explicitly repudiate Fitch, Moody's, and S&P credit ratings, ESG ratings, and underlying methodologies. Likewise, my working paper presents ground-breaking empirical work on one origin of the 2008 financial crisis that academicians and journalists purposely ignore.

I developed robust credit rating methodologies at Moody's. Since resigning in 2010, I have taught myself to be a public-citizen advocate by following financial practitioner leads in speaking to media, co-authoring academic papers and op-eds, and submitting public responses to proposals to regulate and assign credit ratings to complex-finance bonds. However, I break from industry practice in working entirely in the public domain, whereas industry representatives augment public relations with closed-door, off-the-record meetings with policymakers such as financial regulators. The Commodity

Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) are the main U.S. regulators of the swap-contract-with-flip-clause.

Holding the Line Against Complex-Finance Pays Off Just in Time

My open-door policy paid off last month when I submitted the most recent of a series of joint, public critiques of the swap-contract-with-flip-clause to the CFTC, the SEC, and the SEC-regulated Moody's Investors Service. Within days, Moody's publicly scrapped a proposed ESG-complex-finance product, citing as rationale an earlier of my public critiques. Moody's also posted that earlier critique, i.e., Moody's posts irrefutable information that the deficient methodology for the swap-contract-with-flip-clause produces inaccurately high credit ratings for complex-finance bonds throughout the world. I advocate that any person, anywhere, who wishes to improve the content of credit ratings do the same and submit public methodology critiques to credit rating companies.

Also, in response to my joint critiques, the SEC enacted a paradigm switch regarding the swap-contract-with-flip-clause by setting my work as the baseline for SEC regulation. For the eleven years prior to the switch, contract defenders ignored contract deficiencies, or breezily dismissed the deficiencies as historic sidebar applicable only to pre-2008 markets for U.S. residential mortgages. Going forward, contract defenders must publicly do the impossible, namely, disprove my work showing that each contract undermines economic efficiency and financial stability. The paradigm shifts also means that I no longer must continually demonstrate to the SEC that the contract cannot work in theory or practice. Instead, I merely must file public rebuttals to material that financial practitioners submit to the SEC file. I'll also add more of my work such as this *Croatan View* to the file at my own convenience.

At time of posting, no financial practitioner had supplied material to the SEC file, although many would probably like to. Higher U.S. interest rates are likely producing another lobbying go-round to revive the swap-contract-with-flip-clause using an alarmist fiction that the contract is necessary to "hedge" interest rates. U.S. practitioners may also point to non-U.S. counterparts because dealmakers in the rest of the world use the contract widely. Indeed, European, Japanese, and Australian policymakers, as well as international regulatory entities, apply misguided groupthink in facilitating contract use as economically essential.

Fortunately for everyone in the U.S., our administrative law means that practitioners must go through the public file to obtain SEC regulatory "relief" for the swap-contract-with-flip-clause. Even if, as could well occur, practitioners cut a private deal with future SEC commissioners to revive the contract, enacting regulation must publicly address my critiques or fail as being "arbitrary, capricious, [and] an abuse of discretion".

Next in Line, the CFTC and U.S. Complex-Finance Around the World

I am pushing the CFTC to enact a similar paradigm shift, but the regulator balks at following the SEC lead in maintaining a public comment file for my analogous petition for the CFTC to ban the flip clause.

> "*For its part, the CFTC fails its mission, the common good, and all Americans by failing to maintain an analogous public file of § 13.1 petitions for rulemaking. On May 26, 2020, I filed a petition for the CFTC 'to issue a rule that prohibits a Swap Dealer, Major Swap Participant, or other regulated entity from predicating a swap obligation on a flip clause, walk-away, or variable subordination.'*"
> - "Joint Submission to CFTC, SEC, and Moody's Investors Service", October 20, 2022, page 2

I am urging the CFTC to do better. In the interim, U.S. administrative law *does* obligate the CFTC to explicitly factor my joint submission to the CFTC, SEC, and Moody's in regulating U.S. entities that contract complex-finance in Japan, including U.S. regulated entities that provide the swap-contract-with-flip-clause in Japan. Furthermore, CFTC regulation viz-a-viz Japan will set precedent for regulation of U.S. entities that contract complex-finance everywhere else in the world. Stopping U.S. entities from using the contract abroad will help permanently stop them from reviving the contract at home.

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