



## **At SEC, a Scholar Who Saw It Coming**

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By KARA SCANNELL

To protect the financial system from the next potentially toxic innovation or the next Bernard Madoff, the Securities and Exchange Commission has turned to a college professor who warned back in 1993 that derivatives could cause major problems for financial firms.

Henry Hu, who studied biochemistry and worked as a deal lawyer, has made a specialty of figuring out how finance can go awry in unexpected ways. "It's the low-probability catastrophic event that can kill a bank," said Mr. Hu in an interview.

His critics say Mr. Hu's imagination sometimes runs beyond reality, and charge that his theories could lead the government to meddle too much in Wall Street's affairs.

But the professor's out-of-the-box thinking is what attracted SEC Chairman Mary Schapiro to recruit him to run the agency's first new division in 37 years. She called him out of the blue to offer the job heading the Division of Risk, Strategy and Financial Innovation, or RiskFin, after reading an opinion article he wrote on the near collapse of American International Group.

His job, she said in an interview, is "to help us really rethink risk management and help us attract different skill sets to the agency as we try to remake the organization."

To help with the task, Mr. Hu brought in another well-known critic of financial innovation, David Bookstaber. The former risk manager for large hedge funds is focusing on how to better train SEC staff and marshal the data the agency collects.

Mr. Bookstaber, whose 2007 book warned of a looming financial crisis, told Congress that derivatives are "vehicles for gambling," and he has urged a "flight to simplicity" in financial products.

Because RiskFin isn't actively writing rules, "they're a little bit of a think tank in some ways," said Ms. Schapiro. "Sometimes a person comes in and is looking at something for the first time and asks the basic questions...that people who are experts have stopped thinking about."

In the back of everyone's mind are the twin breakdowns at the SEC that emerged in 2008. The agency was flat-footed in oversight of Wall Street firms that made risky bets on mortgage securities and missed the decades-long Madoff fraud.

Staffers from Mr. Hu's division are shadowing SEC examiners. "Once we know what it is they're actually doing, we can figure out what is the best way to train them, rather than pulling a book off of a shelf," said Mr. Hu.

Mr. Hu is also advising Ms. Schapiro as the SEC plans for a possible regulatory overhaul by Congress that would give it more power to regulate derivatives. Mr. Hu is pushing for strong steps, saying the legislation should "prevent a gaming of rules that really should apply to everybody."

The Taipei-born 53-year-old studied biochemistry at Yale, worked as a deal lawyer, and then spent 20 years at the University of Texas in Austin, delving into the hard-to-understand products that define modern finance. He acts more like an enthusiastic professor than a jaded Washington bureaucrat, waving his arms and emphasizing points with "boy" and "wouldn't that be neat."

In his 1993 article "Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism," Mr. Hu described how financial innovation could lead Wall Street astray. When financiers dream up new products, he wrote, they have an incentive to downplay the risks and use them to generate short-term profits—as well as big bonuses.

In particular, he warned about what he called low-probability catastrophic events. That was a premonition of AIG's near-collapse in 2008, triggered partly by the firm's use of certain types of derivatives that were tied to mortgages. Financial institutions such as AIG hadn't predicted credit and liquidity for the products would dry up so fast.

"He's been a Cassandra," said federal judge Patrick Higginbotham in Dallas, a former boss.

Mr. Hu and a colleague have written about a scenario in which a bank lends money to a company but uses derivatives to eliminate any exposure if the company goes bankrupt. Mr. Hu calls the bank in such a case an "empty creditor," and says it is dangerous because it undermines a basic assumption in financial markets: that creditors act in the interests of the debtor's survival.

In a Wall Street Journal opinion article in April 2009—which Ms. Schapiro says prompted the job offer from the SEC—Mr. Hu suggested Goldman Sachs Group Inc. used a kind of derivative called a credit default swap to turn itself into an empty creditor of AIG. He wrote that this may have encouraged Goldman to push for extra collateral from AIG, even when that threatened AIG's existence.

Lucas van Praag, a spokesman for Goldman Sachs, said for a number of reasons the bank "doesn't think that its transactions with AIG are appropriate examples of Prof. Hu's thesis."

The derivatives trade association, the International Swaps and Derivatives Association, later criticized the research, saying the empty-creditor hypothesis is "appealing on the surface" but "is not consistent with either the way credit default swaps work nor with observed behavior in debt markets."

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