

Could Cap and Trade Cause Another Market Meltdown?

The same Wall Street players that upended the economy are clamoring to open up a massive market to swap, chop, and bundle carbon derivatives. Sound familiar?

—By [Rachel Morris](#)

You've heard of credit default swaps and subprime mortgages. Are carbon default swaps and subprime offsets next? If the [Waxman-Markey climate bill](#) is signed into law, it will generate, almost as an afterthought, a new market for carbon derivatives. That market will be vast, complicated, and dauntingly difficult to monitor. And if Washington doesn't get the rules right, it will be vulnerable to speculation and manipulation by the very same players who brought us the financial meltdown.

Cap and trade would create what Commodity Futures Trading commissioner Bart Chilton anticipates as a \$2 trillion market, "the biggest of any [commodities] derivatives product in the next five years." That derivatives market will be based on two main instruments. First, there are the carbon allowance permits that form the nuts and bolts of any cap-and-trade scheme. Under cap and trade, the government would issue permits that allow companies to emit a certain amount of greenhouse gases. Companies that emit too much can buy allowances from companies that produce less than their limit. Then there are carbon offsets, which allow companies to emit greenhouse gases in excess of a federally mandated cap if they invest in a project that cuts emissions somewhere else—usually in developing countries. Polluters can pay Brazilian villagers to not cut down trees, for instance, or Filipino farmers to trap methane in pig manure.

In addition to trading the allowances and offsets themselves, participants in carbon markets can also deal in their derivatives—such as futures contracts to deliver a certain number of allowances at an agreed price and time. These instruments will be traded not only by polluters that need to buy credits to comply with environmental regulations, but also by financial services firms. In

fact, a [study](#) (PDF) by Duke University's Nicholas Institute for Environmental Policy Solutions anticipates that if the United States passes a cap-and-trade law, the derivatives trade will probably exceed the market for the allowances themselves. **"We are on the verge of creating a new trillion-dollar market in financial assets that will be securitized, derivatized, and speculated by Wall Street like the mortgage-backed securities market," says Robert Shapiro, a former undersecretary of commerce in the Clinton administration and a cofounder of the US Climate Task Force.**

Banks like JPMorgan Chase, Morgan Stanley, and Goldman Sachs already have active carbon trading desks that deal in instruments connected to Europe's cap-and-trade system and voluntary markets here. But business will explode if a cap-and-trade system becomes law. So it's no surprise that the financial industry has taken an intense interest in the fine print of the Waxman-Markey bill. According to data compiled by the Center for Public Integrity, the financial services industry has 130 lobbyists working on climate issues, compared to almost none in 2003. They represent companies like Goldman Sachs, JPMorgan Chase, and AIG (before it was shamed into temporarily halting its lobbying activities last fall). The industry "wants lawmakers to create a brand-new revenue stream for its bottom line, and cap and trade would do it," says Tyson Slocum of Public Citizen, who is a member of a Commodity Futures Trading Commission (CFTC) advisory committee considering how carbon trading should be regulated.

Among environmental groups, there is, understandably, less focus on the finer points of financial regulation. "The derivatives side is not something that a person who comes to the table worried about carbon emissions has on their agenda," says Michael Greenberger, a derivatives expert at the University of Maryland who has also served in the CFTC and the Justice Department. "Those people—and they're fighting a good battle—opened the door."

Already, the industry has achieved its main objective: The Waxman-Markey bill would create a big, convoluted market for carbon derivatives. Experts from the Congressional Budget Office

have said that the most stable and effective form of cap and trade would involve a system in which the government periodically sets prices in much the same way that the Fed determines interest rates. That would prevent volatility, which would in turn remove the temptation to gamble on big price swings. In other words, it would provide far less opportunity for wheeling and dealing—and profits. Rep. Jim McDermott (D-Wash.) offered a proposal for a managed-price cap-and-trade scheme, but failed to gain any traction. Meanwhile, industry groups like the International Swaps and Derivatives Association pushed for a system in which a "broad suite" of financial products can be traded, and that's what Waxman-Markey delivers.

In an especially audacious move, the industry also argued that cap and trade should allow the very same types of unregulated instruments that helped spread risk throughout the financial system like a cancer, contributing to the economic meltdown. In particular, it lobbied for "over the counter" carbon derivatives—deals conducted directly between two parties with no one monitoring the risk. (Perhaps the most notorious form of OTC derivative is the credit default swap, which crippled AIG when it issued too many high-risk swaps while lacking the money to cover them.)

On this front, however, Wall Street was less successful. The day before the bill passed out of committee, Rep. Bart Stupak (D-Mich.) [inserted language](#) requiring all allowance derivatives to be either traded on an exchange or cleared by an organization registered with the CFTC. This would provide a paper trail for regulators, although the reporting requirements for clearinghouses are less stringent than those for public exchanges. Stupak also added limits to prevent speculators from cornering too much of the market. Still, the bill leaves many vital specifics to the White House, directing the president to form a task force to determine precisely how to avoid "fraud, market manipulation and excess speculation." Andy Stevenson, finance adviser at the National Resources Defense Council, says, "I would feel comfortable if much more of it were explicit." He applauds the bill's "spirit" but cautions that "the details are important."

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