

argue with. Thus, a Ponzi economy occurring within some sector has strong disincentives to accurately assess risk.

Further complicating the assessment of risk are incentives to unrealistic ratings issued by credit rating agencies (Levin et al. 2011). Since an insurer cannot trust that CRA ratings are necessarily accurate, then to rate risk properly, perhaps establishing that rating agencies for CDS use must be paid by the ~~sellers~~ of CDS instruments rather than providers of the underlying financial instrument may prove effective.

buyers

Significantly complicating the assessment of risk is material that has come to light as a result of SEC prosecution. For instance, Citigroup is accused of lying to investors who bought securities, claiming they were selected by an independent agent. Those securities went into default, and Citigroup had bought CDS's against the underlying securities (Rakoff 2011; Wyatt 2011). It is easy to see that it is more profitable for a bank to make a poor quality loan, buy a CDS, sell off the low quality loan under false representation, then collect on the CDS, than it would be to simply make the loan and collect interest on it after fees. This is a strong incentive to economically pathological banking behavior.

This pathological complication of modern finance represents a serious concern for evaluation of risk by insurers. Buying a CDS on a security which is believed by the buyer to be soon insolvent is, at best, a relationship in which good faith does not exist. The buyer knowingly withholds information critical to the seller. In those cases no actuarial model applies. For the initial issuer, such a sale has similarities to an insurer selling a fire insurance policy to an arsonist or life insurance to a person intending suicide. Like arson or suicide, determining intent or knowledge of the buyer can be difficult.

It would seem that for buyers of CDS instruments the ability of an insurer to pay should be part of their trading model. Thus, at least in a system without publicly funded rescue, rational players would limit the number of bad-faith CDS acquisitions in order to ensure that they would be paid off. However, in a system which is lacking in transparency, it is difficult to determine what the liabilities of major CDS issuers are.

Being unable to determine net liabilities of a CDS issuer creates serious problems, even in a system without publicly funded rescue. Where it is not practical to determine the liabilities of a CDS issuer and rational players are aware that the issuer must collapse eventually, a rational player should maximize bad-