Credit Default Swaps: Evolving Financial Meltdown and Derivative Disaster Du Jour

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Global Research Editor's Note

This important article was initially published in April 2008 several months before the 2008 financial meltdown.

Since September 2008, the Derivative Disaster du Jour spearheaded by Wall Street has reached new heights. It is the cause of the global economic crisis. Policy-makers are committed to maintaining the speculative onslaught which has contributed to destroying the real economy.

Michel Chossudovsky, December 5, 2012

When the smartest guys in the room designed their credit default swaps, they forgot to ask one thing – what if the parties on the other side of the bet don't have the money to pay up? Credit default swaps (CDS) are insurance-like contracts that are sold as protection against default on loans, but CDS are not ordinary insurance.

Insurance companies are regulated by the government, with reserve requirements, statutory limits, and examiners routinely showing up to check the books to make sure the money is there to cover potential claims. CDS are private bets, and the Federal Reserve from the time of Alan Greenspan has insisted that regulators keep hands off.

The sacrosanct free market would supposedly regulate itself. The problem with that approach is that regulations are just *rules*. If there are no rules, the players can cheat; and cheat they have, with a gambler's addiction.

In December 2007, the Bank for International Settlements reported derivative trades tallying in at $681 trillion – ten times the gross domestic product of all the countries in the world combined. Somebody is obviously bluffing about the money being brought to the game, and that realization has made for some very jittery markets.

"**Derivatives**" are complex bank creations that are very hard to understand, but the basic idea is that you can insure an investment you want to go *up* by betting it will go *down*. The simplest form of derivative is a short sale: you can place a bet that some asset you own will go down, so that you are covered whichever way the asset moves.

Credit default swaps are the most widely traded form of **credit derivative**. They are bets between two parties on whether or not a company will default on its bonds. In a typical default swap, the "protection buyer" gets a large payoff if the company defaults within a certain period of time, while the "protection seller" collects periodic payments for assuming the risk of default.

CDS thus resemble insurance policies, but there is no requirement to actually hold any asset or suffer any loss, so CDS are widely used just to speculate on market changes. In one blogger's example, a hedge fund wanting to increase its profits could sit back and collect $320,000 a year in premiums just for selling "protection" on a risky BBB junk bond. The premiums are "free" money – free until the bond actually goes into default, when the hedge fund could be on the hook for $100 million in claims. And there's the catch: what if the hedge fund doesn't have the $100 million? The fund's corporate shell or limited partnership is put into bankruptcy, but that hardly helps the "protection buyers" who thought they were covered.

To the extent that CDS are being sold as "insurance," they are looking more like insurance fraud; and that fact has particularly hit home with the ratings downgrades of the "monoline" insurers and the recent collapse of Bear Stearns, a leading Wall Street investment brokerage. The monolines are so-called because they are allowed to insure only one industry, the bond industry. Monoline bond insurers are the biggest protection writers for CDS, and Bear Stearns was the twelfth largest counterparty to credit default swap trades in 2006.1 These players have been major protection sellers in a massive web of credit default swaps, and when the "protection" goes, the whole fragile derivative pyramid will go with it. The collapse of the derivative monster thus appears to be both imminent and inevitable, but that fact need not be cause for despair. The $681 trillion derivatives trade is the last supersized bubble in a 300-year Ponzi scheme, one that has now taken over the entire monetary system. The nation's wealth has been drained into private vaults, leaving scarcity in its wake. It is a corrupt system, and change is long overdue. Major crises are major opportunities for change.

The Wall Street Ponzi Scheme

The Ponzi scheme that has gone bad is not just another misguided investment strategy. It is at the very heart of the banking business, the thing that has propped it up over the course of three centuries. A Ponzi scheme is a form of pyramid scheme in which new investors must continually be sucked in at the bottom to support the investors at the top. In this case, new borrowers must continually be sucked in to support the creditors at the top. The Wall Street Ponzi scheme is built on "fractional reserve" lending, which allows banks to create "credit" (or "debt") with accounting entries. Banks are now allowed to lend from 10 to 30 times their "reserves," essentially counterfeiting the money they lend. Over 97 percent of the U.S. money supply (M3) has been created by banks in this way.[2] The problem is that banks create only the principal and not the interest necessary to pay back their loans, so new borrowers must continually be found to take out new loans just to create enough "money" (or "credit") to service the old loans composing the money supply. The scramble to find new debtors has now gone on for over 300 years – ever since the founding of the Bank of England in 1694 – until the whole world has become mired in debt to the bankers' private money monopoly. The Ponzi scheme has finally reached its mathematical limits: we are "all borrowed up."

When the banks ran out of creditworthy borrowers, they had to turn to uncreditworthy "subprime" borrowers; and to avoid losses from default, they moved these risky mortgages off their books by bundling them into "securities" and selling them to investors. To induce investors to buy, these securities were then "insured" with credit default swaps. But the housing bubble itself was another Ponzi scheme, and eventually there were no more borrowers to be sucked in at the bottom who could afford the ever-inflating home prices. When the subprime borrowers quit paying, the investors quit buying mortgage-backed securities. The banks were then left holding their own suspect paper; and without triple-A ratings, there is little chance that buyers for this "junk" will be found. The crisis is not, however, in the economy itself, which is fundamentally sound – or would be with a proper credit system to oil the wheels of production. The crisis is in the banking system, which can no longer cover up the shell game it has played for three centuries with other people's money.

The Derivatives Chernobyl

The latest jolt to the massive derivatives edifice came with the collapse of Bear Stearns on March 16, 2008. Bear Stearns helped fuel the explosive growth in the credit derivative market, where banks, hedge funds and other investors have engaged in $45 trillion worth of bets on the credit-worthiness of companies and countries. Before it collapsed, Bear was the counterparty to *$13 trillion* in derivative trades. On March 14, 2008, Bear's ratings were downgraded by Moody's, a major rating agency; and on March 16, the brokerage was bought by JPMorgan for pennies on the dollar, a token buyout designed to avoid the legal complications of bankruptcy.

The deal was backed by a $29 billion "**non-recourse" loan** from the **Federal Reserve**. "Non-recourse" meant that the Fed got only Bear's shaky paper assets as collateral. If those proved to be worthless, JPM was off the hook. It was an unprecedented move, of questionable legality; but it was said to be justified because, as one headline put it, "Fed's Rescue of Bear Halted Derivatives Chernobyl." The notion either that Bear was "rescued" or that the Chernobyl was halted, however, was grossly misleading. The CEOs managed to salvage their enormous bonuses, but it was a "bailout" only for JPM and Bear's creditors. For the shareholders, it was a wipeout. Their stock initially dropped from $156 to $2, and 30 percent of it was held by the employees. Another big chunk was held by the pension funds of teachers and other public servants. The share price was later raised to $10 a share in response to shareholder outrage, but the shareholders were still essentially wiped out; and the fact that one Wall Street bank had to be fed to the lions to rescue the others hardly inspires a feeling of confidence. Neutron bombs are not so easily contained.

The Bear Stearns hit from the derivatives iceberg followed an earlier one in January, when global markets took their worst tumble since September 11, 2001. Commentators were asking if this was "the big one" – a 1929-style crash; and it probably would have been if deft market manipulations had not swiftly covered over the approaching catastrophe. The precipitous drop was blamed on the threat of downgrades in the ratings of two major monoline insurers, Ambac and MBIA, followed by a $7.2 billion loss in derivative trades by Societe Generale, France's second-largest bank. Like Bear Stearns, the monolines serve as counterparties in a web of credit default swaps, and a downgrade in their ratings would jeopardize the whole shaky derivatives edifice. Without the monoline insurers' traiple-A seal, billions of dollars worth of triple-A investments would revert to junk bonds. Many institutional investors (pension funds, municipal governments and the like) have a fiduciary duty to invest in only the "safest" triple-A bonds. Downgraded bonds therefore get dumped on the market, jeopardizing the banks that are still holding billions of dollars worth of these bonds. The downgrade of Ambac in January signaled a simultaneous downgrade of bonds from over 100,000 municipalities and institutions, totaling more than $500 billion.3

Institutional investors have lost a good deal of money in all this, but the real calamity is to the banks. The institutional investors that formerly bought mortgage-backed bonds stopped buying them in 2007, when the housing market slumped. But the big investment houses that were selling them have billions' worth left on their books, and it is these banks that particularly stand to lose as the ***derivative Chernobyl implodes***.4

A Parade of Bailout Schemes

Now that some highly leveraged banks and hedge funds have had to lay their cards on the table and expose their worthless hands, these avid free marketeers are crying out for government intervention to save them from monumental losses, while preserving the monumental gains raked in when their bluff was still good. In response to their pleas, the men behind the curtain have scrambled to devise various bailout schemes; but the schemes have been bandaids at best. To bail out a $681 trillion derivative scheme with taxpayer money is obviously impossible. As Michael Panzer observed on SeekingAlpha.com:

As the slow-motion train wreck in our financial system continues to unfold, there are going to be plenty of ill-conceived rescue attempts and dubious turnaround plans, as well as propagandizing, dissembling and scheming by banks, regulators and politicians. This is all happening in an effort to try and buy time or to figure out how the losses can be dumped onto the lap of some patsy (e.g., the taxpayer).

The idea seems to be to keep the violins playing while the Big Money Boys slip into the mist and man the lifeboats. As was pointed out in a blog called “Jesse’s Café Americain” concerning the bailout of Ambac:

It seems that the real heart of the problem is that AMBAC was being used as a “cover” by the banks which originated these bundles of mortgages to get their mispriced ratings. Now that the mortgages are failing and the banks are stuck with them, AMBAC cannot possibly pay, they cannot cover the debt. And the banks don’t wish to mark these CDOs [collateralized debt obligations] to market [downgrade them to their real market value] because they are probably at best worth 60 cents on the dollar, but are being held by the banks on balance at roughly par. That’s a 40 percent haircut on *enough debt to sink every bank involved in this situation* . . . . *Indeed for all intents and purposes if marked to market banks are now insolvent*. So, the banks will provide capital to AMBAC . . . [but] it’s just a game of passing money around. . . . So why are the banks engaging in this charade? *This looks like an attempt to extend the payouts on a vast Ponzi scheme gone bad that is starting to collapse* 5

The banks will therefore no doubt be looking for one bailout after another from the only pocket deeper than their own, the U.S. government’s. But if the federal government acquiesces, it too could be dragged into the voracious debt cyclone of the mortgage mess. The federal government’s triple A rating is already in jeopardy, due to its gargantuan $9 trillion debt. Before the government agrees to bail out the banks, it should insist on some adequate *quid pro quo*. In England, the government agreed to bail out bankrupt mortgage bank Northern Rock, but only in return for the bank’s stock.

On March 31, 2008, The London Daily Telegraph reported that Federal Reserve strategists were eyeing the nationalizations that saved Norway, Sweden and Finland from a banking crisis from 1991 to 1993. In **Norway**, according to one Norwegian adviser, “The law was amended so that we could take 100 percent control of any bank where its equity had fallen below zero.”6 If their assets were “marked to market,” some major Wall Street banks could already be in that category.

Benjamin Franklin’s Solution

Nationalization has traditionally had a bad name in the United States, but it could be an attractive alternative for the American people and our representative government as well. Turning bankrupt Wall Street banks into public institutions might allow the government to get out of the debt cyclone by undoing what got us into it. *Instead of robbing Peter to pay Paul, flapping around in a sea of debt trying to stay afloat by creating more debt, the government could address the problem at its source: <u>it could restore the right to create money to Congress,</u> the public body to which that solemn duty was delegated under the Constitution.*

The most brilliant banking model in our national history was established in the first half of the eighteenth century, in Benjamin Franklin’s home province of Pennsylvania. The local government created its own bank, which issued money and lent it to farmers at a modest interest. The provincial government created enough extra money to cover the interest not created in the original loans, spending it into the economy on public services. The bank was publicly owned, and the bankers it employed were public servants. The interest generated on its loans was sufficient to fund the government without taxes; and because the newly issued money came back to the government, the result was not inflationary.7 The Pennsylvania banking scheme was a sensible and highly workable system that was a product of American ingenuity but that never got a chance to prove itself after the colonies became a nation. It was an ironic twist, since according to Benjamin Franklin and others, restoring the power to create their own currency was a chief reason the colonists fought for independence. The bankers’ money-creating machine has had two centuries of empirical testing and has proven to be a failure. It is time the sovereign right to create money is taken from a private banking elite and restored to the American people to whom it properly belongs.

Ellen Brown, J.D., developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, her latest book, she turns those skills to an analysis of the Federal Reserve and “the money trust.” She shows how this private cartel has usurped the power to create money from the people themselves, and how we the people can get it back. Her eleven books include the bestselling Nature’s Pharmacy, co-authored with Dr. Lynne Walker, which has sold 285,000 copies. Her websites are www.webofdebt.com and www.ellenbrown.com .

NOTES

1 “Credit Swap Worries Go Mainstream,” nakedcapitalism.com (February 17, 2008); Aline van Duyn, “CDS Sector Weighs Bear Stearns Backlash,” Financial Times (London) (March 16, 2008).

2 See Ellen Brown, “Dollar Deception: How Banks Secretly Create Money,” webofdebt.com/articles (July 3, 2008).

3 “Monoline Insurance,” Wikipedia.

4 Jane Wells, “Ambac and MBIA: Bonds, Jane’s Bonds,” CNBC (February 4, 2008).

5 “Saving AMBAC, the Homeowners, or the Banks?”, Jesse’s Café Americain (February 25, 2008).

6 Ambrose Evans-Pritchard, “Fed Eyes Nordic-style Nationalisation of US Banks,” International Business Editor (March 31, 2008).

7 See Ellen Brown, Web of Debt (Third Millennium Press, 2008), chapter 3.