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Credit Default Swaps; The Poison in the Financial System

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In a little more than a decade, Credit Default Swaps (CDS) have ballooned into a multi-billion dollar industry which has changed the fundamental character of the financial system and increased systemic risk by many orders of magnitude. CDS, which were originally created to reduce potential losses from defaulting bonds, has turned into a cash cow for the big banks, generating mega-profits on, what amounts to, nothing more than legalized gambling. In the case of insurance giant AIG, losses from CDS transactions has already cost the American people $150 billion, and yet their still has been no serious effort in Congress to ban them once and for all. Even worse, CDS is the root-cause of systemic risk which connects hundreds of financial institutions together in a lethal daisy-chain that threatens to crash the entire system if one of the main players goes under.

CDS contracts are not cleared on a centralized exchange nor are they government regulated. That means that no one really knows whether issuers of CDS can pay off potential claims or not. It's a Ponzi-insurance racket of the first order. AIG is a good example of a company that gamed the system and then walked away with millions for its efforts. They sold more CDS than they could cover and then–when the debts started piling up around their eyeballs–they trundled off to the Fed for a multi-billion dollar bailout. Fed chief Bernanke later said that he was furious over the AIG's fiasco, but it didn't stop him from shovelling the losses onto the public ledger and making the taxpayer the guarantor for all AIG's bad bets. Keep in mind, that AIG was selling paper that had zero capital backing, an activity is tantamount to counterfeiting. Still, no one has been indicted or prosecuted in the affair. Defrauding clients and then sticking it to Joe six-pack has become de rigueur on Wall Street.

CDS have spider-webbed their way into every corner of the financial system lashing-together banks and other financial institutions in a way that if one defaults the others go down too. This is what's really meant by "too big to fail"; a euphemism which refers to the tangle of counterparty deals which has been allowed to spread–regardless of the risk–so that a handful of banksters can rake in obscene profits. CDS has become the bank cartel's golden goose; a no-risk revenue-generating locomotive that accelerates the transfer of public wealth to high-stakes speculators. If it wasn't for the turbo-charged profits from derivatives transactions, many of the banks would have already gone belly up.

From Dr. Ellen Brown:

> "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…
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> 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." ("Credit Default Swaps: Evolving Financial Meltdown and Derivative Disaster Du Jour", Dr. Ellen Brown, globalresearch.ca)

The numbers boggle the mind, but they are real just the same, as are the losses, which will be eventually shifted onto the taxpayer. That much is certain.

Treasury Secretary Geithner has recently sounded the alarm for more regulation, but it's just another public relations stunt. Geithner is an industry rep whose sole qualification for the job as Treasury Secretary is his unwavering loyalty to the banking establishment. He has no intention of increasing oversight or tightening supervision. All the blather about change is just his way of mollifying the public while he tries to sabotage congressional efforts to re-regulate the derivatives market. In the next few weeks, Geithner will probably roll out a whole new product-line of reforms accompanied with the usual claptrap about free markets, innovation and "protecting the public's interest". It's all fakery; just more tedious sleight-of-hand carried out by agents of the banking industry working from inside the administration. Fortunately, sad sack Geithner is the world's worst pitchman, which means that every word he utters will be parsed by scores of bloggers trying to figure out what he really means. That will make it especially hard to for him to pull the wool over the public's eyes again.

Swaps originated in the 1980s as a way for financial institutions to hedge against the risk of sudden price movements or interest rate fluctuations. But derivatives trading took an ugly turn after congress passed the Clinton-era Commodity Futures Modernization Act of 2000. The bill triggered a sea-change in the way that CDS were used. Industry sharpies figured out how to expand leverage via complex instruments balanced on smaller and smaller morsels of capital. It's all about maximizing profits with borrowed money. CDS provided the perfect vehicle; after all, with no regulators, it's impossible to know who's got enough money to pay off claims. Besides, gambling on the creditworthiness of bonds for which one has no "insurable interest" can be fun; like taking out an insurance policy on a rivals home and waiting for it to burn down. This is the perverted logic of Wall Street, where every disaster ("credit event") turns into a fortune.

Cleaning up the financial system doesn't require a complete ban on CDS. There is a solution to this mess, and it's not complicated. There needs to be strict regulatory oversight of all issuers of CDS to make sure they are sufficiently capitalized, and there needs to be a central clearing-platform for all trades. That's it. (Note: There are serious questions about the IntercontinentalExchange, or ICE, due to its close connection to the banks) Geithner is trying to torpedo the nascent reform-effort by proposing bogus fixes that preserve the banks monopoly on the derivatives issuance. He's the banks main water-carrier. Now we can see why the financial industry is consistently the largest contributor of any group to political campaigns. They need friends in high places so they can continue their scams without interruption.

"Too big to fail" is a snappy PR slogan, but it's largely a myth. No financial institution is too big for the government to take into conservatorship; to put the bad assets up for auction, replace the management and restructure the debt. It's been done before and it can be done again without damaging the broader system. The real problem is separating healthy financial institutions from insolvent ones now that the whole system is stitched together in a complex net of counterparty deals.

Credit default swaps form the bulk of those counterparty transactions, which makes them the main source of systemic risk. To fix the problem, current contracts must be either unwound or allowed to lapse, while new contracts must be traded on a central clearinghouse where regulators can decide whether sellers are adequately capitalized or not. The Fed's solution–underwriting the entire financial system to prevent another Lehman Bros. fiasco—doesn't address the fundamental problem; it just puts more pressure on the dollar which is already beginning to buckle. The question now is whether Congress will pull their heads out of the sand long enough to do the people's work and pass the laws that will re-regulate the system. There is a remedy, but it requires action, and fast. Without course-correction, the prospect of a derivatives meltdown gets bigger by the day.