

Financial Destabilization, Credit Default Swaps (CDS) and the Rating Agencies

By [Eric Toussaint](#)

Global Research, September 24, 2011

CADTM 24 September 2011

Region: [Europe](#), [USA](#)

Theme: [Global Economy](#)

Eric Toussaint interviewed by the CADTM

In July-September 2011 the stock markets were again shaken at international level. The crisis has become deeper in the EU, particularly with respect to debts. The CADTM interviewed Eric Toussaint about various facets of this new stage in the crisis.

CADTM: You haven't talked about Credit Default Swaps (CDSs) yet.

Eric Toussaint: CDSs are a derivative financial product which is not submitted to any form of public control. They were created in the first half of the 1990s in the middle of the era of deregulation. Credit Default Swap literally means permutation of unpaid debts. Normally, it should allow the holder of a loan to obtain compensation from the CDS seller in the case of default by the bond-issuer, whether a government or a private company. I use the conditional for two main reasons. Firstly, a CDS can be bought as protection against the risk of non repayment of a bond that the buyer does not have. This is the same as taking out insurance for the house next door, hoping that it will catch fire so that one can get the money. Secondly, CDS sellers do not begin by banking enough funds to indemnify victims of defaults. If a whole lot of private companies having issued bonds should go bankrupt, or if a major lender State should default on payments, it is quite certain that CDS sellers would be incapable of indemnifying as promised. In 2008, the collapse of the North-American company AIG, the biggest international insurance company (which was actually nationalized by Bush to avoid the consequences of bankruptcy) and that of Lehman Brothers were directly linked to the CDS market. AIG and Lehman had both been very active in this sector.

The CDS enables all sorts of manipulations. I had the opportunity to observe closely an attempt at manipulation when I was a member of the audit commission for the internal and external debts set up by the government of Ecuador in 2007, which delivered its report in September 2008. While we were auditing the Ecuadorian debt and President Rafael Correa was threatening to stop paying the illegitimate part of the debt to the international money markets, a private North-American company contacted the Ecuadorian government with a most edifying proposal. The company suggested that President Correa should let it be known that he was going to suspend payments just before the next due-date three weeks later. This would enable the company to sell CDSs for a value they had calculated at USD 300 million. The final outcome was supposed to be as follows: in reality, Ecuador would pay what it owed as usual. This would mean that the company would not need to indemnify the CDS holders and it would give half the proceeds to the Ecuadorian government. The company claimed that this operation was completely free of any risk of prosecution as it would be an over-the-counter transaction outside US government control. It claimed to have

already carried out similar transactions on several occasions. In the end, the Ecuadorian government refused the offer, opting for another strategy which produced good results. The point about this true-life story is that it illustrates that issuers and buyers of CDSs can carry out all sorts of manipulations. Let us not forget that right up until the AIG disaster and the collapse of Lehman Brothers, the IMF, the US Federal Reserve and the ECB repeatedly claimed that CDSs were a new product that offered excellent guarantees against risks (see the box on CDSs). Since then, their discourse has changed, but nothing, absolutely nothing, has been done to regulate the CDS market. Meanwhile, in view of the size of the phenomenon, CDSs constitute a huge time-bomb hanging over the international finance system. The fact is that CDS should be outlawed.

Box: Monetary and financial authorities have encouraged the creation of a time-bomb composed of CDSs.

In 2007 when the crisis had already broken out in the USA and was spreading to the EU, Alan Greenspan, former Director of the US Federal Reserve, wrote: “A recent financial innovation of major importance has been the credit default swap. The CDS, as it is called, is a derivative that transfers the credit risk, usually of a debt instrument, to a third party, at a price. Being able to profit from the loan transaction but transfer credit risk is a boon to banks and other financial intermediaries, which, in order to make an adequate rate of return on equity, have to heavily leverage their balance sheets by accepting deposit obligations and/or incurring debt. Most of the time, such institutions lend money and prosper. But in periods of adversity, they typically run into bad-debt problems, which in the past had forced them to sharply curtail lending. This in turn undermined economic activity more generally. A market vehicle for transferring risk away from these highly leveraged loan originators can be critical for economic stability, especially in a global environment. In response to this need, the CDS was invented and took the market by storm. The Bank for International Settlements tabulated a world-wide notional value of more than \$20 trillion equivalent in credit default swaps in mid-2006, up from \$6 trillion at the end of 2004. The buffering power of these instruments was vividly demonstrated between 1998 and 2001, when CDSs were used to spread the risk of \$1 trillion in loans to rapidly expanding telecommunications networks. Though a large proportion of these ventures defaulted in the tech bust, not a single major lending institution ran into trouble as a consequence. The losses were ultimately borne by highly capitalized institutions—insurers, pension funds, and the like—that had been the major suppliers of the credit default protection. They were well able to absorb the hit. Thus there was no repetition of the cascading defaults of an earlier era.”[3]

In 2007 the IMF issued the following declaration referring to the health of the United States and particularly CDSs, labelled new risk-transfer markets: “Although complacency would be misplaced, it would appear that innovation has supported financial system soundness. New risk transfer markets have facilitated the dispersion of credit risk from a core where moral hazard is concentrated to a periphery where market discipline is the chief restraint on risk-taking. (...)Although cycles of excess and panic have not disappeared — the subprime boom-bust being but the latest example — markets have shown that they can and do self-correct.” (IMF, 2007 Consultations Report , article 4 with the United States)[4].

Clearly, certain supposedly reputable banks are still covering themselves against defaults through CDSs. Thus the Deutsche Bank announced at the end of July 2011 that it had reduced its exposure regarding the Italian debt by 88%. The principal German lender claims

to have reduced its exposure in Italy from EUR 8 billion to EUR 997 million. According to the Financial Times, the Deutsche Bank achieved this not by selling over 7 billion euros' worth of Italian bonds, but by a stroke of book-keeping wizardry, buying up CDSs to hedge its investments against possible default on the part of Italy.[5]

On another level, hedge funds, particularly active on the OTC and CDS markets, are worried at the perspective of the Greek debt being partly written off. They are wondering whether they will retain enough street cred to continue selling CDSs once they have failed to indemnify CDS holders of the Greek debt.[6]

CADTM: How much responsibility do rating agencies bear for the crisis?

Eric Toussaint: The North-American Standard & Poor's and Moody's and the Franco-American Fitch are the three private agencies which rule the roost regarding credit ratings and the credibility of bond issuers, whether they be State or corporate.[7] They have existed for almost a century but it was not until the 1970s-1980s, with the financialization of the economy, that their business took a sudden leap. However they are constantly in a situation of conflict of interests. Until the 1970s, it was the prospective buyers of bonds issued by the State and by companies who paid rating agencies for their advice on the quality of the issuers. Since then, the situation has been completely reversed: now it is the issuers of bonds who pay the agencies to rate them. What motivates the government and the companies is of course to get good ratings so that they can pay the lowest possible interest rates to those who buy their bonds. Let us recall that until the eve of the collapse of Enron in 2001, highly paid rating agencies attributed top marks to the power supplier. Again, in 2008, it was the same story with the investment banks, Merrill Lynch and Lehman Brothers. And again with Greece in 2009-early 2010. These are ample demonstrations of the harm they do. They should be sued for the damage caused by the results of the ratings they hand out. Risk assessment is a task which should only be entrusted to public bodies.

Translated from French by Christine Pagnouille and Vicki Briault in collaboration with Judith Harris

Notes

[1] See the first part "Greece" <http://www.cadtm.org/Greece> , the second part "The great Greek bond bazaar" <http://www.cadtm.org/The-great-Greek-bond-bazaar>, the third part "The ECB, ever loyal to private interests" <http://www.cadtm.org/The-ECB-ever-loyal-to-private>, and the fourth part "A European Brady deal: austerity for life" <http://www.cadtm.org/A-European-Brady-deal-austerity>

[2] Éric Toussaint, doctor in political sciences (University of Liège and University of Paris 8), president of CADTM Belgium, member of the president's commission for auditing the debt in Ecuador (CAIC), member of the scientific council of ATTAC France, coauthor of *La Dette ou la Vie*, Aden-CADTM, 2011, contributor to ATTAC's book *Le piège de la dette publique. Comment s'en sortir*, published by Les liens qui libèrent, Paris, 2011.

[3] Alan Greenspan, *The Age of Turbulence, Adventure in a New World*, London, Penguin, 2007, pp. 371-2.

[4] See <http://www.imf.org/external/pubs/ft/scr/2007/cr07265.pdf> . For more on the IMF's errors of judgement concerning the USA and Ireland, see: François Sana "Zéro de conduite

pour le FMI" <http://www.cadtm.org/Zero-de-conduite-pour-le-FMI>

[5] Financial Times, "Deutsche hedges Italian risk", 27 July 2011, p. 13.

[6] Financial Times, "Greek rescue plan worries hedge funds", supplement FTfm, 8 August 2011.

[7] There are others, such as the Chinese Dagong, but they have little influence.

Eric Toussaint www.cadtm.org 345 Avenue de l'Observatoire 4000 Liège Belgique

The original source of this article is CADTM
Copyright © [Eric Toussaint](#), CADTM, 2011

[Comment on Global Research Articles on our Facebook page](#)

[Become a Member of Global Research](#)

Articles by: [Eric Toussaint](#)

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca
www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca