It’s the Derivatives, Stupid! Why Fannie, Freddie, AIG had to be Bailed Out

By Ellen Brown
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> “I can calculate the movement of the stars, but not the madness of men.” – Sir Isaac Newton, after losing a fortune in the South Sea bubble

Something extraordinary is going on with these government bailouts. In March 2008, the Federal Reserve extended a $55 billion loan to JPMorgan to “rescue” investment bank Bear Stearns from bankruptcy, a highly controversial move that tested the limits of the Federal Reserve Act. On September 7, 2008, the U.S. government seized private mortgage giants Fannie Mae and Freddie Mac and imposed a conservatorship, a form of bankruptcy; but rather than let the bankruptcy court sort out the assets among the claimants, the Treasury extended an unlimited credit line to the insolvent corporations and said it would exercise its authority to buy their stock, effectively nationalizing them. Now the Federal Reserve has announced that it is giving an $85 billion loan to American International Group (AIG), the world’s largest insurance company, in exchange for a nearly 80% stake in the insurer . . . .

The Fed is buying an insurance company? Where exactly is that covered in the Federal Reserve Act? The Associated Press calls it a “government takeover,” but this is not your ordinary “nationalization” like the purchase of Fannie/Freddie stock by the U.S. Treasury. The Federal Reserve has the power to print the national money supply, but *it is not actually a part of the U.S. government*. It is a private banking corporation owned by a consortium of private banks. *The banking industry just bought the world’s largest insurance company, and they used federal money to do it*. Yahoo Finance reported on September 17:

“The Treasury is setting up a temporary financing program at the Fed’s request. The program will auction Treasury bills to raise cash for the Fed’s use. The initiative aims to help the Fed manage its balance sheet following its efforts to enhance its liquidity facilities over the previous few quarters.”

Treasury bills are the I.O.U.s of the federal government. We the taxpayers are on the hook for the Fed’s “enhanced liquidity facilities,” meaning the loans it has been making to everyone in sight, bank or non-bank, exercising obscure provisions in the Federal Reserve Act that may or may not say they can do it. What’s going on here? Why not let the free market work? Bankruptcy courts know how to sort out assets and reorganize companies so they can operate again. Why the extraordinary measures for Fannie, Freddie and AIG?

The answer may have less to do with saving the insurance business, the housing market, or the Chinese investors clamoring for a bailout than with the greatest Ponzi scheme in history, one that is holding up the entire private global banking system. What had to be saved at all costs was not housing or the dollar but the financial derivatives industry; and the precipice from which it had to be saved was an “event of default” that could have collapsed a *quadrillion dollar* derivatives bubble, a collapse that could take the entire global banking system down with it.

The Anatomy of a Bubble

Until recently, most people had never even heard of derivatives; but in terms of money traded, these investments represent the biggest financial market in the world. Derivatives are financial instruments that have no intrinsic value but derive their value from something else. Basically, they are just bets. You can “hedge your bet” that something you own will go up by placing a side bet that it will go down. “Hedge funds” hedge bets in the derivatives market. Bets can be placed on anything, from the price of tea in China to the movements of specific markets.

“The point everyone misses,” wrote economist Robert Chapman a decade ago, “is that buying derivatives is not investing. It is gambling, insurance and high stakes bookmaking. Derivatives create nothing.”1 They not only create nothing, but they serve to enrich non-producers at the expense of the people who *do* create real goods and services. In congressional hearings in the early 1990s, derivatives trading was challenged as being an illegal form of gambling. But the practice was legitimized by Fed Chairman Alan Greenspan, who not only lent legal and regulatory support to the trade but actively promoted derivatives as a way to improve “risk management.” Partly, this was to boost the flagging profits of the banks; and at the larger banks and dealers, it worked. But the cost was an increase in risk to the financial system as a whole.2

Since then, derivative trades have grown exponentially, until now they are larger than the entire global economy. The Bank for International Settlements recently reported that total derivatives trades exceeded one quadrillion dollars – that’s *1,000 trillion dollars*.3 How is that figure even possible? The gross domestic product of all the countries in the world is only about 60 trillion dollars. The answer is that gamblers can bet as much as they want. They can bet money they don’t have, and that is where the huge increase in risk comes in.

Credit default swaps (CDS) are the most widely traded form of credit derivative. CDS 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 from the “protection seller” if the company defaults within a certain period of time, while the “protection seller” collects periodic payments from the “protection buyer” 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 increase profits by gambling on market changes. In one blogger’s example, a hedge fund 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 both parties are claiming the derivative as an *asset* on their books, which they now have to write down. Players who have "hedged their bets" by betting both ways cannot collect on their winning bets; and that means they cannot afford to pay their losing bets, causing other players to also default on their bets.

The dominos go down in a cascade of cross-defaults that infects the whole banking industry and jeopardizes the global pyramid scheme. The potential for this sort of nuclear reaction was what prompted billionaire investor Warren Buffett to call derivatives "weapons of financial mass destruction." It is also why the banking system cannot let a major derivatives player go down, and it is the banking system that calls the shots. The Federal Reserve is literally owned by a conglomerate of banks; and Hank Paulson, who heads the U.S. Treasury, entered that position through the revolving door of investment bank Goldman Sachs, where he was formerly CEO.

The Best Game in Town

In an article on FinancialSense.com on September 9, Daniel Amerman maintains that the government's takeover of Fannie Mae and Freddie Mac was not actually a bailout of the mortgage giants. It was a bailout of the financial derivatives industry, which was faced with a $1.4 trillion "event of default" that could have bankrupted Wall Street and much of the rest of the financial world. To explain the enormous risk involved, Amerman posits a scenario in which the mortgage giants are *not* bailed out by the government. When they default on the $5 trillion in bonds and mortgage-backed securities they own or guarantee, settlements are immediately triggered on $1.4 trillion in credit default swaps entered into by major financial firms, which have promised to make good on Fannie/Freddie defaulted bonds in return for very lucrative fee income and multi-million dollar bonuses. The value of the vulnerable bonds plummets by 70%, causing $1 trillion (70% of $1.4 trillion) to be due to the "protection buyers." This is more money, however, than the already-strapped financial institutions have to spare. The CDS sellers are highly leveraged themselves, which means they depend on huge day-to-day lines of credit just to stay afloat. When their creditors see the trillion dollar hit coming, they pull their financing, leaving the strapped institutions with massive portfolios of illiquid assets. The dreaded cascade of cross-defaults begins, until nearly every major investment bank and commercial bank is unable to meet its obligations. This triggers another massive round of CDS events, going to $10 trillion, then $20 trillion. The financial centers become insolvent, the markets have to be shut down, and when they open months later, the stock market has been crushed. The federal government and the financiers pulling its strings naturally feel compelled to step in to prevent such a disaster, even though this rewards the profligate speculators at the expense of the Fannie/Freddie shareholders who will get wiped out. Amerman concludes:

"[I]t's the best game in town. Take a huge amount of risk, be paid exceedingly well for it and if you screw up — you have absolute proof that the government will come in and bail you out at the expense of the rest of the population (who did not share in your profits in the first place)."4

Desperate Measures for Desperate Times

It was the best game in town until September 14, when Treasury Secretary Paulson, Fed Chairman Ben Bernanke, and New York Fed Head Tim Geithner closed the bailout window to Lehman Brothers, a 158-year-old Wall Street investment firm and major derivatives player. Why? “There is no political will for a federal bailout,” said Geithner. Bailing out Fannie and Freddie had created a furor of protest, and the taxpayers could not afford to underwrite the whole quadrillion dollar derivatives bubble. The line had to be drawn somewhere, and this was apparently it.

Or was the Fed just saving its ammunition for AIG? Recent downgrades in AIG’s ratings meant that the counterparties to its massive derivatives contracts could force it to come up with $10.5 billion in additional capital reserves immediately or file for bankruptcy. Treasury Secretary Paulson resisted advancing taxpayer money; but on Monday, September 15, stock trading was ugly, with the S & P 500 registering the largest one-day percent drop since September 11, 2001. Alan Kohler wrote in the Australian Business Spectator:

“[I]t’s unlikely to be a slow-motion train wreck this time. With Lehman in liquidation, and Washington Mutual and AIG on the brink, the credit market would likely shut down entirely and interbank lending would cease.”5

Kohler quoted the September 14 newsletter of Professor Nouriel Roubini, who has a popular website called Global EconoMonitor. Roubini warned:

“What we are facing now is the beginning of the unravelling and collapse of the entire shadow financial system, a system of institutions (broker dealers, hedge funds, private equity funds, SIVs, conduits, etc.) that look like banks (as they borrow short, are highly leveraged and lend and invest long and in illiquid ways) and thus are highly vulnerable to bank-like runs; but unlike banks they are not properly regulated and supervised, they don’t have access to deposit insurance and don’t have access to the lender of last resort support of the central bank.”

The risk posed to the system was evidently too great. On September 16, while Barclay’s Bank was offering to buy the banking divisions of Lehman Brothers, the Federal Reserve agreed to bail out AIG in return for 80% of its stock. Why the Federal Reserve instead of the U.S. Treasury? Perhaps because the Treasury would take too much heat for putting yet more taxpayer money on the line. The Federal Reserve could do it quietly through its “Open Market Operations,” the ruse by which it “monetizes” government debt, turning Treasury bills (government I.O.U.s) into dollars. The taxpayers would still have to pick up the tab, but the Federal Reserve would not have to get approval from Congress first.

Time for a 21st Century New Deal?

Another hole has been plugged in a very leaky boat, keeping it afloat another day; but how long can these stopgap measures be sustained? Professor Roubini maintains:

“The step by step, ad hoc and non-holistic approach of Fed and Treasury to crisis management has been a failure. . . . [P]lugging and filling one hole at [a] time is useless when the entire system of levies is collapsing in the perfect financial storm of the century. A much more radical, holistic and systemic approach to crisis management is now necessary."6

We may soon hear that "the credit market is frozen" – that there is no money to keep homeowners in their homes, workers gainfully employed, or infrastructure maintained. But this is not true. The underlying source of all money is government credit – *our own public credit*. We don't need to *borrow* it from the Chinese or the Saudis or private banks. The government can issue its own credit – the "full faith and credit of the United States." That was the model followed by the Pennsylvania colonists in the eighteenth century, and it worked brilliantly well. Before the provincial government came up with this plan, the Pennsylvania economy was languishing. There was little gold to conduct trade, and the British bankers were charging 8% interest to borrow what was available. The government solved the credit problem by issuing and lending its own paper scrip. A publicly-owned bank lent the money to farmers at 5% interest. The money was returned to the government, preventing inflation; and the interest paid the government's expenses, replacing taxes. During the period the system was in place, the economy flourished, prices remained stable, and the Pennsylvania colonists *paid no taxes at all*. (For more on this, see E. Brown, "Sustainable Energy Development: How Costs Can Be Cut in Half," webofdebt.com/articles, November 5, 2007.)

Today's credit crisis is very similar to that facing Herbert Hoover and Franklin Roosevelt in the 1930s. In 1932, President Hoover set up the Reconstruction Finance Corporation (RFC) as a federally-owned bank that would bail out commercial banks by extending loans to them, much as the privately-owned Federal Reserve is doing today. But like today, Hoover's ploy failed. The banks did not need more loans; they were already drowning in debt. They needed customers with money to spend and invest. President Roosevelt used Hoover's new government-owned lending facility to extend loans where they were needed most – for housing, agriculture and industry. Many new federal agencies were set up and funded by the RFC, including the HOLC (Home Owners Loan Corporation) and Fannie Mae (the Federal National Mortgage Association, which was then a government-owned agency). In the 1940s, the RFC went into overdrive funding the infrastructure necessary for the U.S. to participate in World War II, setting the country up with the infrastructure it needed to become the world's industrial leader after the war.

The RFC was a government-owned bank that sidestepped the privately-owned Federal Reserve; but unlike the Pennsylvania provincial government, which originated the money it lent, the RFC had to borrow the money first. The RFC was funded by issuing government bonds and relending the proceeds. Then as now, new money entered the money supply chiefly in the form of private bank loans. In a "fractional reserve" banking system, banks are allowed to lend their "reserves" many times over, effectively multiplying the amount of money in circulation. Today a system of public banks might be set up on the model of the RFC to fund productive endeavors – industry, agriculture, housing, energy — but we could go a step further than the RFC and give the new public banks the power to create credit themselves, just as the Pennsylvania government did and as private banks do now. At the rate banks are going into FDIC receivership, the federal government will soon own a string of banks, which it might as well put to productive use. Establishing a new RFC might be an easier move politically than trying to nationalize the Federal Reserve, but that is what should properly, logically be done. If we the taxpayers are putting up the money for the Fed to own the world's largest insurance company, we should own the Fed.

Proposals for reforming the banking system are not even on the radar screen of Prime Time politics today; but the current system is collapsing at train-wreck speed, and the "change" called for in Washington may soon be taking a direction undreamt of a few years ago. We need to stop funding the culprits who brought us this debacle at our expense. We need a public banking system that makes a cost-effective credit mechanism available for homeowners, manufacturing, renewable energy, and infrastructure; and the first step to making it cost-effective is to strip out the swarms of gamblers, fraudsters and profiteers now gaming the system.

NOTES

1. Quoted in James Wesley, "Derivatives – The Mystery Man Who'll Break the Global Bank at Monte Carlo," SurvivalBlog.com (September 2006).

2. "Killer Derivatives, Zombie CDOs and Basel Too?", Institutional Risk Analytics (August 14, 2007).

3. Kevin DeMeritt, "$1.14 Quadrillion in Derivatives – What Goes Up . . . ," Gold-Eagle.com (June 16, 2008).

4. Daniel Amerman, "The Hidden Bailout of $1.4 Trillion in Fannie/Freddie Credit-Default Swaps," FinancialSense.com (September 10, 2008).

5. Alan Kohler, "Lehman End-game," Business Spectator (Australia) (September 15, 2008).

6 Ibid.

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, and Forbidden Medicine.

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